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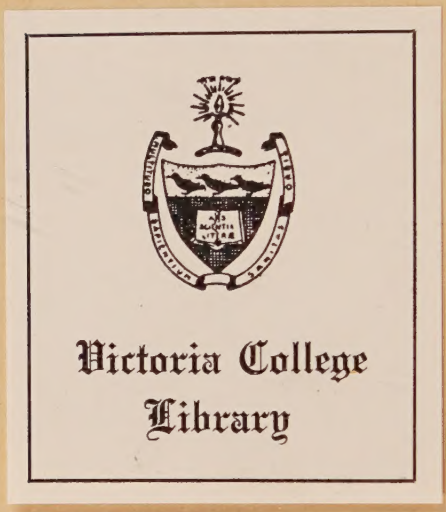

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PRINCIPLES OF FOREIGN TRADE

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PREFACE

INTERNATIONAL trade was one of the first subjects of inquiry pursued by modern economists. These economists, in their early treatments of the question, centered their attention almost exclusively upon the theory of international values, an aspect of the subject which even to-day is recognized as presenting the chief contrast with domestic trade. With the development of education for business, another type of book appeared dealing with the technique of international trading, especially of exporting. The two types of books were utterly different in point of view and were mutually exclusive as to content. In the present treatment a position midway between these extremes has been adopted. If this treatment has led to a neglect of some of the technical details of actual commerce and of some of the finer points of economic theory, it is believed that the sacrifices are justified by the objects in view.

Probably in no field of economic activity is there greater divergence between scientific doctrine on the one hand and the popular views of business men and the policies of governments on the other. It is the opinion of the writer that governmental policies and broad business policies can and should proceed from a rational and systematic theory of trade. With this thought in mind it follows that the writer has little patience with the idea that theory and practice should be divorced: the one to hold sway in philosophic circles, the other to govern in the actual conduct of affairs. Sound theory must be made up in view of the facts, and wise policy must be consistent with sound theory.

The aim of this book, therefore, is to bring the teachings of accepted economic theory into the realm of business and governmental policy. Such an attempt, it is hoped, will not be devoid of interest to business men, who do not need to be instructed in the technique of exporting, but who may perhaps profit

by an exposition of the economic principles underlying their daily activities. The principal purpose, however, is to give a broad economic basis for those young men and women who are now pursuing the academic part of their training for business. Further, the group of students kept in mind is not those who will make a special vocation of exporting or importing but the much larger number of future business men and women who will have occasional contact with problems of foreign marketing in the conduct of domestic businesses and who will certainly, as intelligent business people, have use for a rational basis for their views on governmental and national commercial policy.

The recognition of the need for a book which, while dealing with the actual conduct of trade, was more concerned with the "why" of such trade than with the "how to do it" was the occasion for undertaking the present work. In its present form it was preceded by three mimeograph editions, each of which has been used in the class room and modified in the light of that experience.

For valued suggestions and assistance at one point or another in the preparation of the present book thanks are due to my colleagues Professor W. A. Paton, Messrs. G. S. Peterson, and E. H. Cramer, and to Professor W. P. Calhoun of the University of Cincinnati.

C. E. GRIFFIN.

Ann Arbor, Michigan.
April, 1924.

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PRINCIPLES OF FOREIGN TRADE

PRINCIPLES OF FOREIGN TRADE

CHAPTER I

ELEMENTARY PRINCIPLES OF TRADE

Foreign trade and domestic trade are special manifestations of the same general phenomenon of exchange. There are some differences between them, but the similarities are more essential than the differences. The similarities lie in the nature of trade itself. We shall, therefore, find it profitable to direct our attention at the outset to certain principles of trade, some of which are so elementary that their significance is likely to be missed.

Principles Common to All Trade

All trade consists of an exchange of goods and services for other goods and services. This is perfectly apparent in a simple barter transaction. It is equally true in our modern economy, although the fact is partially disguised by the use of money. But money is a medium of exchange: it is obtained by the sale of goods or services, and it is used for the purchase of goods or services. Therefore, if we look at all below the surface, we will see that money is really a convenient mechanism for bringing about the exchange of goods or services, which is the essence of trade. Attention will be directed in later pages to this mechanism and the part which it plays in trade, but it should always be borne in mind that money is important as it performs, more or less effectively, this service of facilitating the exchange of other things.

Every transaction in trade is both a purchase by one party

and a sale by another. It therefore follows that, if we have in mind the sum of all transactions, the number and value of all purchases must be equal to the number and value of all sales. Further, the purchases and sales of each individual must be equal, although they need not be made at the same time nor with the same traders. This is indicated by a consideration of a very simple series of transactions involving only three traders. A sells $1000 worth of goods to B; B sells $1000 worth to C; and C sells $1000 worth to A. Stated otherwise; B buys from A; C buys from B; and A buys from C. It is apparent that the series of transactions would break down, if A refused to buy from C, for then C would lack the means to buy from B, and B would lack the means to buy from A. The same is true of every trader in the series. The purchases of each trader must be just equal to his sales. The series can be indefinitely extended but always with the same result. Certain qualifications should be made to adapt this illustration to actual commerce. First, A need not spend his whole $1000 with C. He might buy $500 worth of goods from B and $500 from C, who in turn buys $500 worth from B, but A's sales and purchases are still equal. Second, when we speak of A "spending" or "buying" we must remember that he may be buying machinery or permanent plant, which in business usage would be called investing. The above principle is, therefore, not a spendthrift doctrine. Third, if we consider these transactions as taking place continuously, it will be seen that A may sell at one time and buy later or that he may buy now (on credit) and sell later. All goes well if the deferred purchases and the deferred sales are made in due course. If, however, the former lag unduly all trade is checked to that extent. Business men term such a state of affairs a "buyers' strike." If the sales are delayed more than usual, trade is also checked, and business men speak of "frozen credits." No business man needs to be told that the two phenomena are closely connected.

The principle discussed in the preceding paragraphs is known as the principle of reciprocity: an individual's purchases from all individuals must equal his sales to all individuals. In this

principle is one of the similarities of foreign and domestic trade, for it is as true of individuals considered as national groups as it is of them considered separately. The total value of goods and services received from foreign countries must be equal to the value of goods and services rendered to foreign countries, that is, purchases must equal sales. Among the services in international trade are shipping services, the use of foreign capital, services rendered to tourists in foreign lands, and others. These are invisible imports, or exports, as the case may be. Including these, there must be an equality between imports and exports.

Not only must a country as an individual buy as much as it sells, but it would be unwise to try to do otherwise. Consumption of goods is the end and object of the economic process. We produce in order that we may consume, and increased production is desirable, because it makes possible increased consumption. This again is as true of foreign as of domestic trade. We produce goods and export them, in order that we may, thereby, obtain other goods in greater quantity, or the same amount of goods at less inconvenience, than if we tried to produce those goods ourselves. This is the object and justification of all trade.

To say that the values of the goods given and received are equal is not to say that there is no benefit from the trade. Many people seem to think that if we export $1,000,000 worth of goods and also import $1,000,000 worth of goods there can be no gain to us. We have just come out even. Not so. If A has ten bushels of wheat and sells five of them to B for five dollars, and then uses the five dollars to buy a pair of shoes, perhaps from B, he has undoubtedly been benefited by the exchange, and so has B. The pair of shoes was more important to A than was the five bushels of wheat, although the exchange value of the two were the same. If B had not been benefited also, he would have refused to trade. The situation can be summarized in two propositions, first, the benefits of trade are not to be discovered in a comparison of the exchange value of the goods received with that of those given, but rather in the relative importance of the

goods given and the goods received to each individual (or country); and, second, the benefits of trade (domestic or foreign) must be mutual. The benefit to the two parties to a trade need not be equal. In fact, the benefits may be so unequal as to appear to be very unjust, but, in the opinion of each trader, there must be a gain or the trade could not take place. So it is between nations, but the division of the gain between the trading countries is a complicated question, which will be considered later. Here we only insist upon the simple proposition that the benefits are mutual and that international trade is not in the nature of a swindle.

The last point to be mentioned in this connection is not a principle of trade but merely a statement of fact. It is that international trade to-day is carried on between individuals or other private business units in one country with other individuals or business units in other countries. The present government of Russia does engage in trade, and so did the Western European countries during the war; but ordinarily when we speak of "England" trading with the United States or with Argentina, we are speaking figuratively. For some purposes a country can be considered as a unit, and usually, even when this is not strictly correct, no harm results. In some cases, however, unwarranted conclusions may follow from this premise. With the exceptions noted, foreign trade, like domestic trade, is carried on by individuals, each seeking his own personal profit.

The principles which have been discussed so far apply to all trade whether conducted by barter or by the intricate methods of modern commerce, and whether the trade be domestic or foreign. They can be summarized as follows: (1) All trade is essentially an exchange of goods and services. (2) Goods are given (sold) as a means of getting (buying) other goods. The getting and consuming of goods is the end; the production and sale is a means to this end. (3) The value of goods and services given must be equal to the value of those received. (4) The benefits of trade are not to be found in a difference between sales and purchases, but in the greater importance to each individual or

nation of the goods received than of those given. (5) Benefits must be mutual though not necessarily equal. (6) Trade is at present conducted by individuals, each seeking his own personal profit.

Popular Disregard of These Principles

These propositions are rarely denied in direct terms, but they are often disregarded or denied by implication in popular discussions. For example, the second proposition is implicitly denied in the very common view that the value of our foreign trade arises from the fact that it serves as an outlet for our surplus goods. The propaganda of banks, commercial organizations, and of the government is directed to increasing our export trade much more than to facilitating imports. This may be justified on the ground that other countries will look after their exports, which are our imports. But, nevertheless, it appears that the concern felt over the one and the neglect of the other is due in large part to a confusion of means and ends. The abnormal conditions accompanying and following the recent war have forced several economic principles upon the attention of the American people, and one of these is that there is a necessary relation between exports and imports. But even those who admit a relationship between the two often think of the imports as a necessary evil, which must be borne if we are to export,—as though in a trade of my services for the goods of the grocer, I should grudgingly accept the latter only that I might dispose of the former. More specifically, this view is illustrated by the argument often made by those who favor cancellation of European debts to us. The argument runs that the making of the loans was really not a burden to us, because the proceeds were spent here and thus increased our exports. It is no doubt true that, with business organized as it is, such loans and exports do create a superficial prosperity, but fundamentally a country is not made rich by producing and exporting goods, if these do not lead to a return of other goods or services, which it desires more than it did the goods given. The opponents of cancellation seem

to be in agreement with its advocates on this point, for they take great pains to prove that not all the funds loaned were spent here. All this implies that "making work" for American industry is the desired end. The view of the present writer is that this work is only a means to obtaining desired goods, by a roundabout process and, if those goods are not forthcoming, the work might better have been diverted to direct production of goods for domestic consumption or have been saved altogether. When we come to the possible payment of the debts we are confronted by essentially the same argument in a somewhat different form; namely, that to accept payment would likely result in increasing our imports, to our great harm. It is true that a repayment of the debts would tend to increase our imports compared to our exports, and also that if eleven billion dollars were to be repaid in a very short time disastrous effects would likely follow, both in the paying and receiving countries. But there is no possibility of such a sudden payment. Spread over a period of decades, such a payment would mean that we would, during that period, have at our disposal more of goods and services than we would otherwise have enjoyed. A conclusion that this is undesirable must rest upon grounds which transcend economic common sense. Reference is made to this much controverted question, only because it so aptly illustrates a disregard of one of the principles of trade, which appears to be fundamental. Needless to say, these remarks are not to be taken as an expression of opinion on the whole question. Several arguments are advanced in favor of cancellation which command respectful attention if not assent.

The errors discussed, if so they be, probably arise from a disregard of the first proposition stated above, that trade is an exchange of goods and services. In practice, trade is divided into two parts: the sale of goods for money, and the use of the money to buy other goods. It is very easy to become so concerned with the first phase of exchange as to forget that it is useful only as it makes possible the second.

Implied denial of the third proposition, regarding the essential equality of exports and imports, are so common as hardly to

need specific illustration. That exports could and should exceed imports was a principal tenet of most economic writers from the fifteenth to seventeenth centuries and, although it has received little credence in systematic expositions of trade since that time, it does continue, with remarkable tenacity, to influence popular discussion and even governmental policy. A later chapter will be devoted to the balance of trade. People who recognize the necessity of buying as well as selling often slip into another error in applying the generalization to our trade with a particular country or region. For example, it is asserted that we cannot expect to sell to South America unless we buy from South America. There may be some basis for this view on the score of friendly business relations, but the principle of reciprocity of trade gives no support to it. The requirements of that principle are entirely met by a sale of goods to South America and corresponding purchases from England or Africa or any other part of the world.

The most popular views concerning the importance of a favorable balance of trade (excess of merchandise exports over merchandise imports) also violates the fourth principle stated above, concerning the nature of the benefits of trade. It is implied that the benefits of trade to a country are to be measured in terms of dollars and are proportional to the difference between the dollar value of exports and imports. If this were true there would be no benefit for, if there be such an excess, it is offset by invisible items which are of equal value. The benefit is not so easily measured. It lies in the facts that by trade we get some goods, which we would otherwise have to do without altogether, and that other goods, which we could produce at home, are obtained more easily and in greater abundance by the indirect method of trade. It is, therefore, impossible to say that our foreign trade is worth so many dollars to us. That it is very valuable we can be sure, but in the nature of the case its value is not measurable.

Much of the discussion of the tariff and much of the diplomacy involved in modern tariff-making amounts to a denial of the fifth proposition, that the benefits of trade are mutual. It

is generally recognized that a high tariff barrier is a blow to the foreign exporter, but it is sometimes forgotten that it may be equally burdensome to domestic consumers. Trade is of benefit to the buyer as well as to the seller. It is difficult to put one's finger on clear cut manifestations of the error, but there seems, nevertheless, to exist a very general assumption that in buying from foreigners we confer a favor upon them and that in selling we receive such favors.

Even the almost self-evident proposition that modern trade is carried on by individuals and corporations each seeking its own profit is sometimes accorded less than its due weight. For example, in a recent discussion of the desirability of the United States having a large merchant marine, it was argued that it was as unwise to rely upon foreign ships for the carrying of American exports as it would be for a department store to rely upon the delivery system of its chief competitor for the delivery of its goods. An American merchant marine may be desirable, but a moment's consideration of the fact that "our" competitors are individual Englishmen or English firms, and that the "delivery system" is owned by other individual Englishmen, who are presumably actuated by the desire to handle the most profitable trade, and not primarily by the desire to advance the interests of traders who happen to be citizens of their own country, will indicate that the analogy is quite misleading. This notion seems to underlie the recent demands for American ships, American banks, American insurance companies, and American merchants, as necessary foundations for American foreign trade. These may be, and some of them, no doubt, are, desirable, but their importance can easily be overemphasized. At any rate, a true understanding of international trade will not be facilitated by an assumption at the outset that England, or any other country, is one great trading unit bent upon destroying all foreign competition. Whatever may be the desires of individual foreigners, reasonably fair service may be expected from foreign agents, because the forces of competition, even between individuals of the same country, compels it.

These examples of popular views on foreign trade indicate that the simple propositions concerning trade, set forth above, are constantly disregarded or by implication denied, and that unwarranted conclusions may rest upon assumed differences between foreign and domestic trade, which do not in fact exist.

Differences Between Foreign and Domestic Trade

There are, however, certain differences which justify separate treatment of the two types of trade. First, all trade to-day is conducted in terms of money, but, whereas in domestic trade the same monetary unit is employed by both buyers and sellers, we often find two or more different units in a single transaction or series of transactions in foreign trade. In principle, this is not an essential distinction, but in fact, and especially at a time like the present when the relative values of these monetary units are constantly changing, it does constitute an important practical distinction. Fundamentally trade is an exchange of goods for goods, but proximately it is controlled by prices in terms of these monetary units. For a considerable time, therefore, trade may be guided almost entirely by these superficial factors.

Second, trade within a country is ordinarily quite free of the obstructions of strange languages, customs, and commercial laws, but these obstructions may be of great importance in international trade. The large trade of some countries with their colonies, which is usually ascribed to the direct influence of political control, is, no doubt, largely due to the absence of obstacles of this kind, which confront other countries desiring to trade with these colonies. Likewise, the habits of consumption of peoples vary according, or partly according to their race and type of civilization. Hence trade between countries having the same racial, political, and cultural characteristics, flows more freely than between countries where these conditions are quite different. The very large trade between the United States and the several English speaking parts of the British Empire is an example. Third, tariffs and other artificial obstacles play a part in international trade and are largely absent in domestic trade.

A more fundamental difference, and the one which calls for a special theory of international trade, is the fact that production in different countries is carried on in more or less closed or non-competing compartments, while production in any one country is accompanied by a direct competition for the several agents of production. In both types of trade the producers are competing in the sale of their products, and, since American and Japanese products, for example, must compete in the same open market, they must sell at similar prices, allowance being made for differences in the quality of the goods. But in the production of these goods the Japanese and American manufacturers do not compete for the same workers, nor for the same land, nor do they compete freely for the same capital, although there is more international competition for the last named factor than for the other two. One manufacturing industry in the United States competes with other manufacturing industries for the services of the same laborers and the manufacturing industries compete with agriculture. The automobile industry of Detroit, for example, competes with the farmers of Michigan for labor. During an industrial boom thousands of farms will be idle for lack of workers, many of whom return to the farms when the demand of the manufacturers falls off. This competition for the agents of production extends over our whole country. Laborers can, and do, shift from one employment to another in response to the wage offered and, therefore, the wages in the several industries must bear a rather definite relationship to one another. For this result to be obtained, it is not necessary that all laborers should be foot-free and willing to change, but merely that a considerable number (in the technical language of economics, the marginal workers) should be so influenced by competitive forces. Thus, broadly speaking, there is at any time a fairly similar return to laborers of the same quality in different industries and in different parts of the country.

It follows from this that within the same country goods will tend to exchange on the basis of their "real" cost of production, *i. e.*, on the basis of the amount of labor and effort involved in their production. If the same amount of labor (that immedi-

ately employed and that previously employed to prepare the machinery, raw materials, and the like) be required for the production of units of two products and if this labor be similarly remunerated, due to the mobility of the labor, we should expect the products to exchange one for the other on equal terms. People do expect them to exchange on these terms and if they do not so exchange it is concluded that some temporary disturbance has altered their natural relationship. From the mobility of labor and from the resulting tendency of wages for similar kinds of labor to reach a uniform level, it follows that within the same country, if there be a difference in the amount of labor required to produce any easily transportable article in one section as compared to others, the article will be produced where the real costs are lowest.

But if we compare two countries we find a quite different situation. The cotton manufacturers of the United States do not compete with the cotton manufacturers of Japan for their labor. There is, therefore, no reason for expecting that a product which requires one day of labor in the United States will exchange on equal terms for another product requiring the same amount of labor in Japan. Nor can we conclude that an article will be produced in the United States, rather than in Japan, merely because it requires two days to produce it in the latter country and only one day in the former. We could quite safely reach such a conclusion as between New York and Maine, but not between the United States and Japan.

We have seen that these differences are due to the fact that labor within a country is relatively mobile while between countries it is relatively immobile. Laborers do, of course, move from one country to another, as is clear from the volume of immigration into the United States. This migration, no doubt, has an effect of bringing the wage levels in the several countries nearer together than they otherwise would have been, but the obstacles to such migration are effective, even in this day of easy and cheap transportation. Home ties, the difference in language and customs, the expense of the voyage, natural inertia, and sometimes

restrictive immigration laws combine to prevent the free movement of workers from one country to another, and, hence, make possible widely different levels of wages in the several countries.

Likewise, capital does move from country to country, more freely in fact than does labor, but, nevertheless, there are serious obstacles. There is a tendency for investors to place their capital where it will be under their own observation. Where the investors do not insist upon this they may, at any rate, prefer to have their capital invested in their own country where they are accustomed to the ways of doing business, where the difficulty of placing their funds may be least, where they can feel sure that international difficulties will not result in confiscation of their property or repudiation of the obligations involved, and where they can be sure that their property will be protected against the acts of lawless members of the community. All of these considerations may lead to the employment of capital in countries where the return to capital is lower than could be obtained elsewhere. This in itself tends to perpetuate differences in interest rates.

We have seen that this immobility of labor and capital between different countries is not complete and, therefore, countries are not, as regards one another, perfect noncompeting groups. On the other hand, the mobility of labor and capital between parts of the same country is not perfect and, hence, competition between parts of the same country is not perfect. The distinction between national and international trade is, therefore, one of degree, but the difference in degree is great enough to justify different modes of treatment.

The Bases of International Trade

It was remarked above that both countries involved in trade must gain by that trade. It appears, therefore, that there must be an absolute or net gain, for one's gain is not at the expense of the other. This is made possible by the fact that international trade enables countries to specialize in the production of those things which, all things considered, they are best fitted to produce. By this mode of production, the labor and effort involved

yield a larger total product than would be possible if each produced, or tried to produce, all the products which it needed.

Suppose, for example, that two countries are each producing and consuming both manufactured products and agricultural products. For greater definition we can think of cotton cloth as typical of the manufactured products and wheat as representative of the agricultural products. Suppose that country A has an advantage in producing the wheat and country B an advantage in producing cloth. We may indicate this relationship by setting forth the days of labor required to produce the two products in the two countries as follows:

To produce	requires in A	requires in B
Wheat (1 bushel)	2 days of labor	1 day of labor
Cloth (1 yard)	1 day of labor	2 days of labor

Now if each country produces its own products those products will exchange at quite different ratios in the two countries. In A, wheat will be the more costly and will normally have a higher exchange value. The goods will exchange at the following ratios in the two countries:

In A 1 bushel of wheat = 2 yards of cloth
In B 2 bushels of wheat = 1 yard of cloth

It is this difference in the exchange value of the products that leads to trade. Merchants will find that in A they can procure 2 yards of cloth for 1 bushel of wheat, and that in B they can sell the 2 yards of cloth for 4 bushels of wheat. Or they could start from B, where they could buy 2 bushels of wheat for 1 yard of cloth, and sell the 2 bushels of wheat in A for 4 yards of cloth. The first merchants who engage in this trade will be able to retain all the profit for themselves; but very soon their own competition in buying the one product and selling the other will lead to a division of most of the gain between the consumers of A and B.

Before going further into this division of the gain, let us make clear that there is a gain in total product. Extensive trade of this kind causes each country to devote all its labor to producing the product for which it has a natural advantage. This leads to

increased total production. This increased production is the real source of the gains of international trade. It is a net gain for the trading countries as a group, not merely a gain made by one at the expense of the others.

A comparison of the labor cost and the combined products of the two countries before and after specialization will emphasize the point. If each country produces both products, these results will be attained:

Country	*Labor cost*	*Product*
A	3 days	1 cloth + 1 wheat
B	3 days	1 cloth + 1 wheat
Combined results	6 days	2 cloth + 2 wheat

If A produces cloth and B produces wheat:

Country	*Labor cost*	*Product*
A	3 days	3 cloth
B	3 days	3 wheat
Combined results	6 days	3 cloth + 3 wheat

The total product has been increased by specialization from 2 units of cloth and 2 of wheat to 3 units of cloth and 3 of wheat.

Now to return to the division of the gain, the merchants will find it unusually profitable to buy cloth in A at the existing terms of 1 bushel of wheat for 2 yards of cloth. They will, therefore, press this trade, until by the forces of competition, they are led to offer somewhat more of wheat for the cloth. On the other hand, their desire to dispose of cloth in B at the old ratio of 2 bushels of wheat for 1 yard of cloth will force them to give somewhat more of cloth for the wheat. The resulting alterations of the exchange ratios in A and in B will be favorable to the people of those countries, respectively, and unfavorable to the merchants. This shifting of exchange ratios will continue until the profits of the merchants are reduced to the same rate as they could make in other trades, due allowance being made for the risks of the business. The gains from international trade, therefore, are not to be found in the profits of the traders, but rather in the larger amount of wheat which the people of A can obtain, and the larger amount of cloth which the people of B can obtain, when their labor is employed in this roundabout way than when it is employed directly

in obtaining those goods. This discussion refers primarily to the transfer of gains from the merchants to the producers and consumers of the two countries. Since it may be necessary for the merchants to make greater concessions to one country than to the other, the benefits of trade need not be equally divided between the two countries.

The condition which led to the trade just described is known as a condition of absolute advantage. One country had an absolute advantage over the other in the production of cloth, and the other held an advantage in wheat. Trade on this basis might well exist between parts of the same country, for there is no necessary advantage to the workers engaging in one industry as compared to the other. The productivity of workers in both A and B could well be the same, and the wages could likewise be the same.

But this is not the only condition which could lead to international trade. Country A might have an advantage over B in the production of both products and still find it profitable to export one and import the other, providing only it had a greater advantage in the production of one than of the other. Likewise B, although it would be at a disadvantage in both lines, would find it profitable to export the one product in which its disadvantage was less and import the one in which its disadvantage was greater. This condition, which is known as one of comparative advantage, is typical of the relations between advanced and backward countries. The workers in the less productive country will, in any event, have smaller incomes than those of the more productive country; but those incomes will be enhanced if the country's industry is so directed as to minimize the natural disadvantage under which it labors.

We can set forth this condition in a manner similar to that employed above.

To produce	requires in A	requires in B
Wheat (1 bushel)	2 days of labor	8 days of labor
Cloth (1 yard)	1 day of labor	2 days of labor

Country A has a greater advantage in wheat production than in cloth production. It will, therefore, be profitable for it to

export wheat and import cloth. Likewise B's comparative disadvantage is less in cloth, and it will, therefore, be profitable for it to produce and export that product and import wheat.

This specialization would be brought about, not by a conscious weighing of the advantages flowing from the different policies, but by the fact that values of either of the goods, measured in terms of the other, will be different in the two countries. For example, in the latter illustration the costs of production in country A would normally bring about an exchange ratio in that country represented by the equation, 1 bushel of wheat = 2 yards of cloth, while in B, 1 bushel of wheat = 4 yards of cloth. These values, be it noted, are determined by the relative cost of the two products in the same country, not by the cost of wheat in A compared to its cost in B. We describe this by saying that the different values of the products in the two countries arise from a difference in the comparative costs of production in the two countries.

This can be emphasized by observing that in the above illustration the same values would have existed in B if the costs of wheat and cloth had been 80 days and 20 days, respectively, or 800 days and 200 days. Under any of these conditions 1 bushel of wheat would normally exchange for 4 yards of cloth; and it is the fact that this ratio of costs and values differs from that existing in B that gives rise to trade. On the other hand, if the comparative costs in the two countries were not different, there would be no basis for trade, even though the actual labor costs of the products were quite different in the two countries. For example, if a bushel of wheat and a yard of cloth were produced in A at 2 days and 1 day, respectively, while in B they were produced at 20 days and 10 days there would be no incentive to trade *because* there would be no difference in the comparative cost. One bushel of wheat would exchange for 2 yards of cloth in both countries.

To return to our illustration, it will clearly be profitable for merchants to buy wheat in A, where 1 bushel can be obtained for 2 yards of cloth, and sell it in B, where 1 bushel exchanges for

4 yards of cloth. This trade will induce a growth of the wheat industry in A and a corresponding decline in the cloth industry, and the opposite shift of industry will take place in B. Thus each country will specialize upon that product in which it has the greatest advantage or the least disadvantage. The resultant gain will be divided between the merchants and the consumers and producers of A and B in the same manner as in the case of absolute advantage described above.

Trade, whether resting upon absolute advantage or comparative advantage, thus seems to be due to the same fact—that the comparative costs of production of goods and, hence, their relative values, are different in different countries. It might, therefore, seem that there is no reason for the distinction, but there is, in fact, a practical difference. Comparative advantage implies a general superiority of one country over the other in production, while absolute advantage implies simply that each country is superior in one group of products and inferior in others. Trade on the former basis enhances the incomes of both the superior and inferior country, but it commonly leaves a difference in income levels, while that on the latter basis is more likely to leave general incomes at approximately the same level in the two countries. The relations existing between parts of the same country are ordinarily those of absolute advantage. Kansas produces wheat with fewer days of labor than could Pennsylvania, and Pennsylvania produces steel with fewer days of labor than could Kansas. Wheat continues to be produced in the one section and steel in the other, because each region can produce its own product with less labor than could the other. Likewise, trade between some countries, where the obstacles to migration of labor and capital are slight, for example, between Canada and the United States, rests on absolute advantage. But China may produce wheat not because she can produce it with less labor than can the United States or other countries, but only because she can produce it in some sections to better advantage than she can other things. If there were none of the economic and non-economic obstacles to migration, the workers of China would

move to the United States or other more favorably situated countries. There is no such incentive for the people of Kansas to move to Pennsylvania or for the people of Pennsylvania to move to Kansas. We can, therefore, say that among countries of much the same civilization, race, social and political conditions, between which the costs and other obstacles to migration are minimized, trade will tend to rest upon absolute advantage, while trade between countries where the obstacles to migration are great will more often rest upon comparative advantage. Trade on the latter basis continues to exist because of the immobility of capital and labor, while that on the former basis is due to natural and more permanent conditions such as special natural resources and climatic conditions.

CHAPTER II

THE PRINCIPLE OF COMPARATIVE COST

The governing principle of international trade, as set forth in economic theory, may be phrased thus: A country tends to export those products in the production of which it has the greatest advantage or the least disadvantage compared with other countries, and it tends to import those products in which it has the least advantage or the greatest disadvantage. Or, we may say that a country tends to export those products which are produced at a lower *comparative* cost within its borders than elsewhere and to import those which are produced at a higher *comparative* cost than elsewhere. This is the law of comparative cost.

The business man, centering his attention upon the day to day transactions of commerce, is likely to state the principle of international trade in this manner: A country exports those products which are lower in price within its borders than elsewhere and imports those which are higher in price at home than abroad.

The latter statement is obviously true: the former is likewise true though it is not so obvious. Trade is immediately or proximately governed by the latter principle; fundamentally it is governed by the former. The purpose of the following discussion is to indicate the manner in which the principle of comparative cost works itself out through the prices of products, and thus to show that the two statements are not only consistent, but that the former necessarily underlies the latter.

Assuming freedom of trade between the countries of the world, wages and prices will so adjust themselves to the productivity of labor in the several countries and to the reciprocal demand for the products of the several countries, that traders will find it profitable to conduct trade on the lines indicated in the principle of comparative cost.

The Operation of the Principle Through Prices [1]

To show how this adjustment of money, wages and prices will come about, assume that we have two countries, which we may call the United States and Japan, both of which are assumed to be using a gold standard currency, and between which trade has not before a certain date existed. If trade, direct or indirect, has not existed between the two countries, there is no necessary relation between money wages and prices in the two countries. Suppose, then, that wages in gold coin happen to be the same in the two countries, say $1.00 per day, if we can for a moment assume the same monetary unit to prevail in the two countries. We may assume further, that there are two products, wheat and cloth, produced in each country, typical of all the other products, and that the costs of production of the two products in the two countries are as follows: In Japan, 1 yard of cloth requires 8 days of labor, and 1 bushel of wheat 8 days of labor; in the United States 1 yard of cloth requires 4 days of labor, and 1 bushel of wheat 1 day. Translating these into terms of dollars, we have the money cost and, therefore normally, the selling price of the two products as follows:

	In Japan	In United States
cloth	$8 per yard	$4 per yard
wheat	$8 per bushel	$1 per bushel

If the barriers to trade are suddenly removed, what happens? Judging from our previous exposition of the principle of comparative advantage, we would say that, since the United States has a greater advantage in the production of wheat than of cloth and since Japan's advantage is less in cloth than in wheat, Japan would produce cloth exclusively, and the United States would produce wheat exclusively. Something like this will happen ultimately, but not immediately, for both products are cheaper

[1] The theories of comparative costs and of the division of gain between the trading countries are developed in some detail in the succeeding pages by the method of hypothetical assumptions familiar to students of economic theory. Some readers may prefer to pass over these pages, resuming the discussion with "A General Statement of the Theory of Trade."

in money terms in the United States than in Japan. At the outset cloth merchants, therefore, will buy cloth in the United States for $4 and sell it in Japan for $8, and wheat merchants will buy wheat in the United States for $1 and sell it in Japan for $8. This means that all the goods flow one way. In the normal course of trade this is an impossible situation, and if we follow through the subsequent change we will see why it is impossible.

Since both classes of goods move from the United States to Japan and no goods from Japan to the United States, the Japanese imports must be paid for with money available in Japan and acceptable in the United States, in this case, gold. But settlement in this manner involves the withdrawal of money from Japan and its injection into the American currency system. This transfer of gold tends to lower the value of money in the United States and to raise its value in Japan. This is equivalent to saying that money wages and prices fall in Japan and rise in the United States, for it is through such changes in prices and money incomes that changes in the value of money show themselves. As the trade described is especially profitable it will proceed rapidly, and the ensuing transfer of money will have a marked effect on the price levels of the two countries. Suppose the price level to decline 50 per cent in Japan and rise by 50 per cent in the United States. We would then have these values in the two countries:

	In Japan	In United States
cloth	$4 per yard	$6 per yard
wheat	$4 per bushel	$1.50 per bushel

It now becomes profitable for merchants to buy wheat in the United States and sell it in Japan, and to buy cloth in Japan for sale in the United States. Thus those products which are produced within a country at the greatest comparative advantage become cheaper in money terms than in foreign countries. If it should happen temporarily that this were not true, there would automatically start a readjustment of prices, money incomes and money wages, as described above, which would bring prices into line and make it commercially profitable to export

some goods and import others. We thus have arrived at the same conclusion as we would have reached in considering only costs in days of labor.

Such a situation as that described in our original assumption, in which all transportable goods are lower priced in one country than in the outside world, cannot permanently endure. A readjustment must take place, whereby prices rise in the low price country or fall in the high price countries or both. In such a readjustment, those products in the low price country which are produced at a comparative disadvantage will first rise above their prices in other countries. Such products will, therefore, be imported. This makes it possible to receive payment for exports without the inflow of gold and, therefore, that flow ceases and prices remain at their new level.

The Division of the Gain from International Trade

So far we have shown that in our assumed case two sided trade will take place and we have indicated which articles will be exported and which imported; we have not shown at what prices they will exchange. Upon the answer to this question will depend the answer to a question raised in a preceding section: how is the gain of international trade divided between the participating countries?

The above illustration can be employed in seeking an answer to these questions. We have arrived at a point in the adjustment of prices at which cloth is valued at $4 in Japan and $6 in the United States, while wheat stands at $4 in Japan and $1.50 in the United States. Now if merchants of the United States take the initiative in this trade, they can for a time both buy cloth and sell wheat at Japan's prices. The wheat for which they pay $1.50 in the United states can be sold in Japan for $4 and the cloth which they buy in Japan for $4 will sell in the United States for $6. This trade, however, being exceptionally profitable, will attract more traders, and their competition in the sale of wheat will normally bring the price almost to $1.50 if we continue to disregard transportation costs. That is, the

price in the foreign market comes to be approximately the same as that prevailing in the producing country. Likewise, the price of cloth in the United States will be forced down by similar forces to about $4 which represents its cost of production in Japan.

The international prices for the products in question are now: wheat $1.50 a bushel, and cloth $4 a yard. Whether or not the products can continue to sell at these prices will depend upon the reciprocal demand for the products by the two countries at these prices. If it should happen that at $1.50 a bushel Japan will take 1,000,000 bushels of wheat, then Japan would owe the United States on this account $1,500,000. This being the case, equilibrium will be established and prices will remain at these levels if, and only if, the United States takes 375,000 yards of cloth, no more and no less. For the purchase of 375,000 yards of cloth at $4 a yard would call for a payment by the United States to Japan of $1,500,000. One payment just offsets the other.

Let us pause a moment to inquire how each country has fared from its trade. The United States is parting annually with 1,000,000 bushels of wheat, for which it receives 375,000 yards of cloth. That is, wheat exchanges for cloth on the following terms:

1,000,000 bushels of wheat	= 375,000 yards of cloth
or, 1 bushel of wheat	= .375 yard of cloth
or, 1 yard of cloth	= 2.66 bushels of wheat

Now the gain to the United States can be seen by this comparison. By specialization and trade the United States now gets 1 yard of cloth for 2.66 bushels of wheat which it produces with 2.66 days of labor. When it produced both wheat and cloth for itself it obtained 1 yard of cloth with 4 days of labor. Apparently it has saved by trade the difference between 2.66 days of labor and 4 days in obtaining its cloth. This is a saving of 33⅓ per cent.

On the other hand, Japan now obtains a bushel of wheat for .375 yard of cloth, which requires, at 8 days to the yard, 3 days to produce (.375×8 days = 3 days). Before trade began it required 8 days of Japanese labor to obtain a bushel of wheat.

Japan has saved 62½ per cent of the labor required to produce a bushel of wheat. Of course, if the countries prefer additional goods to the additional leisure thus made possible, as they probably will, they can employ their saved time in the production of additional goods. We, therefore, can think of the saving from trade in terms of additional goods or of labor saved. We shall for the sake of consistency continue to employ the latter concept.

But why are the gains different in degree? Why did Japan save 62½ per cent of its labor in getting wheat while the United States saved only 32½ per cent in getting its cloth? It was due to the relation between the American demand for cloth and the Japanese demand for wheat. This will be seen if we imagine the American demand for cloth to decline and then see what results would follow. More specifically, we wish to see if such a change in demand will affect the relative gains of the two countries and, if so, in what direction.

Suppose then the American demand for Japanese cloth declines for some reason, perhaps a change of style, until at the price of $4 a yard we buy only 200,000 yards instead of 375,000 yards. Japan's demand for wheat remains unchanged for the time being.

Under these conditions trade will no longer be in equilibrium for now:

Japan will owe the United States	1,000,000 × $1.50	=	$1,500,000
United States will owe Japan	200,000 × $4	=	$800,000
Balance owed by Japan			$700,000

As a result gold to the amount of $700,000 will flow from Japan to the United States. Prices and money incomes will rise in the United States and fall in Japan as described above. Suppose they fall 25 per cent in Japan and advance 25 per cent in the United States. Cloth being affected with all other Japanese products will fall to $3, while wheat, moving with American prices, will rise to $1.87½.

The changes in prices might be more or less than 25 per cent. But they must be in the directions indicated. The nature of the

result will not be affected by the extent of the changes. With these new prices part of the American demand would be recovered, for two reasons: first, the price of the cloth has declined, and second, American money incomes have risen. Likewise, the Japanese demand for wheat would decline for the price of wheat has risen while Japanese money incomes have declined. Suppose that as a result of these changes in price and money incomes, Japan took 500,000 bushels of wheat and the United States took 312,500 yards of cloth. Equilibrium would again be established, for 500,000 bushels of wheat at $1.87½ and 312,500 yards of cloth at $3 call for the same payment—to be exact, $937,500. Therefore, the value of the purchases by one country is just equal to the value of the purchases by the other country. Or, stated otherwise, the purchases and sales of each country just balance one another. The flow of gold ceases, and goods are paid for with goods. We have thus returned to normal two sided trade such as existed before the change in the American demand for cloth.

But, although we have returned again to normal trade relations, the terms of exchange are quite different. Americans now give 500,000 bushels of wheat for 312,500 yards of cloth. This is less wheat for more cloth than before. The terms of exchange are now:

500,000 bushels of wheat = 312,500 yards of cloth,
or 1 bushel of wheat = .625 yard of cloth,
or 1 yard of cloth = 1.6 bushels

The United States now gets 1 yard of cloth for 1.6 bushels of wheat, the production of which requires 1.6 days of labor. Comparing this with the 4 days required to obtain 1 yard of cloth without trade, we now have a saving of 60 per cent of the labor required to obtain cloth. Applying similar reasoning to Japan, we see that it can obtain 1 bushel of wheat for .625 yard of cloth, which, at 8 days to a yard, costs 4.96 days of labor. Comparing this with the days of Japanese labor which would have been necessary to produce the wheat directly, it appears

that Japan now saves 38 per cent of the labor required to obtain a given quantity of wheat.

Now, compare these gains with those which accrued to the two countries at the preceding stage of equilibrium. We found then that the United States saved 33½ per cent in the labor required to obtain its cloth and Japan saved 62½ per cent in obtaining its wheat. Then American demand for cloth fell off. This forced a readjustment of prices between the two countries, as a result of which, the gain to the United States, measured by the same method as before, increased to 60 per cent and Japan's gain declined to 38 per cent. That is, the result of the decline in demand on the part of the Uuited States, was a readjustment of the terms of exchange favorable to it and unfavorable to Japan. If the American demand had increased instead of declining the adjustment would have been made in the opposite direction. Prices of Japanese products and the money incomes of Japanese producers would have advanced, and American prices and incomes would have declined. These changes would have been favorable to Japan and unfavorable to the United States.

It appears, therefore, that, under the assumed conditions of two countries trading exclusively with one another in two products, two conclusions are justified: first, the products will come to exchange one for the other without the necessity of a movement of gold; and second, the terms of exchange will be more favorable to that country whose demand for the other country's product is slight, compared to the foreign demand for its own products, and, conversely, the terms of exchange will be less favorable as its own demand comes to be more intense, compared to the foreign demand for its own products.

But people even in our illustration do not actually barter wheat for cloth. They sell the wheat for a price and buy the cloth as an apparently separate transaction. The terms of exchange, therefore, flow from the prices of the goods sold and of those bought. A favorable adjustment is one which gives a high price for the goods sold and a low price for the goods bought.

This is precisely the kind of adjustment which was effected when the terms shifted in favor of the United States. Or, to bring the statement still nearer to the actualities, many of the people of the countries involved are not even selling the products upon which they work, rather they are receiving money incomes as wages, interest, profits, or rent. These money incomes are spent in part for domestic products and in part for foreign products. Now the shift in international demand, described above, led to an increase, not only of the money price of the goods of the United States, but also to a rise in American *money* wages. Such a change in money wages is of no real significance in the long run in the purchase of domestic goods, for prices and incomes under such circumstances finally come to the same position, relative to each other, on the high level, as they maintained on the low level. During the period of change in price level and income level some prices may move more rapidly than others, and price changes in general may precede or follow wage changes. Rising prices or falling prices may, therefore, affect the relative positions of various classes in the community, but high prices, as compared to low prices, do not. We are concerned here, and in the remainder of this chapter, with the final adjustment, not with the period of transition. A high money wage level thus attained is of no permanent significance as regards domestic transactions, but it is significant in the purchase of foreign goods—Japanese goods, in our illustration. For while American money incomes have risen, Japanese prices have declined. Americans are, therefore, in a better position to buy the Japanese goods. On the other hand, Japanese money incomes declined. This decline of his money income need cause no concern to the Japanese worker as long as he is only buying other Japanese products; but when he turns to American products he finds that their prices have advanced, and he is, therefore, at a disadvantage in purchasing them. Money income levels in the several countries, therefore, are important so far as international trade is concerned, for it is through them that the division of gain between the trading countries is effected.

But they are themselves determined by the conditions of supply of and demand for goods in international trade. Relative price levels are thus important as the mechanism by which fundamental forces are made effective.

Before leaving this assumed case let us see more exactly how money wages would have been affected by the opening of trade. We assumed that before trade was opened between the United States and Japan there prevailed in each country a wage of $1 a day. We might have assumed any other relation of money wages, for as long as countries have no commercial transactions which bring them into contact, either directly or indirectly, with one another, there is no logical relationship between their money wages or prices. But when trade began we have seen that the relative demand for goods and the flow of gold readjusted the wage and price levels.

The costs of the products in the two countries in days of labor have remained the same. It still takes 8 days to produce a unit of cloth in Japan and 1 day to produce a unit of wheat in the United States. But the general price level has declined in Japan and advanced in the United States. The Japanese product (cloth) is now worth $3.00 and the eight days of labor required to produce it will, therefore, still leaving aside other costs, be valued at about 37½ cents. Likewise the American product (wheat) is worth $1.87½; and, as only 1 day is required to produce a bushel of the product, $1.87½ will tend to be the daily wage in the United States.

Now these money wages prevent the two countries from engaging in those industries in which they are less effective. For, if it is possible to employ all workers at wheat production at $1.87½, an equally high wage would have to be paid in cloth production. But at a wage of $1.87½ American cloth producers would be unable to compete successfully with Japanese producers. Likewise, the wage of 37½ cents a day can be paid by Japanese cloth producers; because, considering the amount of labor required in American and Japanese cloth production, this wage will enable the Japanese producer to hold his own against Ameri-

can competition. But the Japanese wheat producer could not afford to pay so much, for the 8 days necessary to produce wheat would, at a wage of 37½ cents, make the wheat cost $3 a bushel. This is considerably higher than the American cost. Wheat production would, therefore, be effectively prevented in Japan. Thus the principle of comparative cost operates through the fact that the most effective industries set a wage so high that the less effective are unable to attract workers.

The case with which we have been dealing is, of course, purely hypothetical. There is no significance in the fact that we designate the two countries as the United States and Japan. The device is employed only because such terms as countries X and Y are, to some readers, awkward. The figures employed are merely designed to facilitate reasoning upon this rather complicated question. For the same reason, the number of products are limited to two, as are also the number of countries. Transportation costs are disregarded and the monetary units in the two countries are assumed to be the same. The general principles deduced, however, are not materially affected by those deviations from the facts. In applying them to actual trade we can, for example, think of the United States on the one hand and all other countries of the world on the other, instead of two countries only. The relative effectiveness of production in the countries, though not accurate when applied to the countries named, are perfectly possible. The costs of transportation act as a drag upon international exchange and thus prevent the principle from working out perfectly. Certain qualifications which need to be made when some of the trading countries are using paper money not acceptable outside their borders, will be noted in connection with the subject of foreign exchange.

A General Statement of the Theory of Trade

We now leave our hypothetical illustration and turn to a statement in more general terms of the principles developed above. The relative cost (in labor and capital required) of producing products differs from country to country. International trade

rests upon these differing comparative costs. If the relative cost of producing iron and lead and wheat and cloth and all other goods and services were exactly the same in the United States, England, and all other countries, there would be no permanent basis for international trade. The mere fact that the production of all of these goods cost twice as much labor in one country as in another, would not lead to trade. The controlling fact is that the advantage which one country has over other countries is greater in some products than in others, or that its disadvantage is less in some products than in others. Given this situation, there is a normal economic basis for trade, for each country will find it profitable to specialize in the production of those products in which its advantage is greatest or its disadvantage is least, *i. e.*, those products in which it has the greatest comparative advantage.

No conscious control upon the part of the communities is needed to bring about this trade. Rather, the stimulus is given by the fact that those products in which a comparative advantage exists are relatively cheap within the borders of a country and others are relatively dear. Individual traders seek their profits by exporting the former and importing the latter. This at first is highly profitable to the traders; but, as the competition of traders stimulated by unusual profits develops, the trading profits decline to the ordinary rate of profits in other lines which involve a similar degree of risk and a similar amount of capital and which demand an equal amount of skill and judgment.

Trade actually takes place on the basis of prices. The world's supply of international money, gold and silver, is so distributed (and other factors also contribute to this result) as to make some products in every country cheaper than they are elsewhere, and others dearer. This is true of all countries, whether they be advanced or backward, and whether their wages be high or low. Not only is this statement borne out by observation of the facts, but it has to be true. It has to be true, because any other condition would automatically destroy itself. If, indeed, transportable products were universally higher priced in one country than

in all other countries, then that country would buy but would not be able to sell. This would require purchases to be made in metallic money and the outflow of gold would lower prices. In this lowering of prices the first products to fall in price below those of similar products in the outside world would be those in which the country had a comparative advantage, that is the greatest advantage or the least disadvantage compared to the other countries. If the country had no gold available for export, the rates of foreign exchange would tend so to adjust themselves, in relation to the prices within the country in question, as to bring about the same result. Explanation of this last proposition must be deferred for the present.

On the other hand, prices cannot decline so far as to make all products cheaper than they are elsewhere, for if this happened the country would sell and not buy. Gold would flow (or exchange rates would be adjusted) so as to raise prices. In this phase of rising prices the first products whose prices would pass above those abroad, would be those in which the country suffered a comparative disadvantage, that is, in which it had the least advantage or the greatest disadvantage compared to the other countries.

This adjustment of the world's gold supply among the several countries is so made that the value of gold in terms of the general list of goods susceptible to international exchange is about the same in all countries. This is another way of saying that the general price level, as far as international goods are concerned, is about the same in all countries. By international goods we mean those goods which in their nature can be transferred from country to country. Houses, railroads, canals, and many other goods and services are necessarily produced in the country of consumption. They are excluded from the above statement that price levels tend to be about the same the world over. Further, the statement refers to the general price level, that is, the average of prices. Some products, those whose comparative cost of production is high, will be somewhat dearer than in the outside world and others, those in which the compar-

ative cost of production is low, will be somewhat cheaper. The prices of specific international goods in any country will tend to differ from the foreign prices by a little more than the cost of transportation from or to the foreign markets. Thus the values of products which we have previously measured in terms of other goods come to be measured in terms of money, that is, they have a "price." Trade then takes place in terms of prices and proximately it is governed by these prices. But, since these prices are high or low accordingly as the products are those in which a country has a comparative advantage or a comparative disadvantage, it appears that the principle of comparative cost as set forth in the last chapter operates through prices. The business man's statement and the economist's statement which were put in opposition at the beginning of this chapter are thus seen to be quite consistent.

The gains which a country enjoys from international trade do not lie on the surface. They are to be found finally in the greater ease in obtaining the imported goods. The effort required to obtain goods through international trade is determined by two factors: (1) the effort required to produce a given quantity of the export goods and (2) the amount of such goods which must be given to obtain a given quantity of imports. The first depends upon the effectiveness of labor in the export industries: the second depends upon the foreign demand for the country's exports and its own demand for the foreign goods. The first can be illustrated by comparing the real incomes of people in two countries exporting the same product to the same markets—say the United States and India exporting wheat to Europe. The wheat, whatever its origin, sells for the same price, but it yields a good income to American producers and a very small one to the Indian producers. This is due to the fact that a bushel of wheat can be produced with much less time and effort in the United States than in India. The producers of the United States derive for the same effort a larger income than those of India because their effectiveness in production is greater.

To illustrate the working of the second factor is not so simple.

Suppose a country to possess a supply of a product, or class of products, not to be found, at least in such abundance, elsewhere. Now if this product is in great demand in foreign countries, it is probable that high prices can be obtained for it. It is true that in the long run the demand of the country in question for foreign products will be great enough to equal in value the goods given, but for a time this latter demand may lag behind the former. Under these circumstances, prices of the export goods will rise and with them the money incomes of the producers of these goods. But, since these producers and the producers of other goods within the country are interchangeable, these high money incomes become general throughout the country. Money prices of all goods will, therefore, advance. As a result of the increased money incomes, the people of the country can buy foreign goods with less labor than before. Thus high money incomes in a country, if the incomes are in a medium acceptable in making foreign purchases, are a source of gain to the people of that country in buying foreign goods. Finally, the value of the goods bought and those sold comes to be equal at the new prices, but these prices are more favorable to the country in question than they would have been if the country's demand for foreign goods had been more intense and the foreign demand for its own products less intense.

This reasoning possibly applies to England during its early industrial development. Cotton cloth and other manufactured goods were offered to foreigners who were anxious to obtain them. The goods, therefore, did not have to be pushed upon the foreign markets. The goods produced by the foreign countries were not in such great demand in England. The result was that, by the steps described above, English money incomes were enhanced and thus Englishmen were placed in a favorable position in buying foreign goods.

The industrial development of Europe has long supplied a market for American raw materials and foodstuffs. This regular and large demand for American products coexisting with a less intense demand on our part for European goods would, if our

reasoning be correct, contribute to making this a country of high money incomes and thus to giving the United States an advantage in exchanging its exports for foreign products. That this result has occurred seems clear, and that the factor just discussed contributed to the result seems probable, although admittedly, it is not susceptible of proof by the inductive method.

Again, it is commonly noted that countries of high incomes, such as Canada, Australia, and the United States, can buy with the products of one day's labor the products of several days of foreign labor. This is usually explained by the fact that the labor of these prosperous countries is very effective in producing the export products; but it should be added that the goods produced for export are those for which there exists a favorable foreign demand. This suggests that the salesmen of a country who introduce their products in foreign markets have a part in influencing the terms of exchange in favor of their country, as well as the inventors or engineers who make more effective the labor of producing the products. The importance of selling efforts of this kind has possibly been exaggerated by business men, but it is equally possible that it has been under-rated by economic theorists.

CHAPTER III

SOME APPLICATIONS OF THE THEORY OF INTERNATIONAL TRADE

The leading principles of international trade have now been set forth. We have seen that the moving force is the greater volume of goods to be obtained by specializing upon the production of those goods in the production of which a comparative advantage is enjoyed and importing those goods as to which a comparative disadvantage exists. This principle is made effective through the adjustments of money wages and prices. It has further appeared that the gain from international trade, though mutual, need not be equal to all parties involved, but that its division is influenced by the reciprocal demands for the products of trade. The division of the gain is also accomplished through adjustment of income levels. With this brief summary we now turn to certain applications of these principles with special reference to the trade of the United States.

Comparative Advantage in the United States

The theory outlined above serves to explain why the United States imports some products, which could be produced with as little or perhaps less effort at home as in the countries from which they are brought. We import flax from Russia and Belgium, although we could produce it here with as little time and energy as is required in those countries. Likewise, coarse wool for rugs and carpets is brought from China, Russia, and Turkey, although our western plains are quite suitable for the production of such wool. Handmade laces and other articles of adornment are imported in large quantities, although it is clear that our natural resources would not prevent the development of such industries here. Even when the very workers, who found it profit-

able to follow these pursuits in their home countries, emigrate to the United States, they or their children give up their old employments for those which are characteristic of this country. Even though their effectiveness in these industries be as great here as in their old homes, their possible effectiveness in other lines is now so much greater that they find it profitable to transfer their efforts to those lines in which their comparative advantage is greatest.

This raises the question, in what lines does the United States enjoy a comparative advantage? There is no one line which stands out as superior to all others. We have a comparative advantage in the production of some agricultural products. This is commonly ascribed to the abundance of excellent land, and this certainly is an important factor, but it is also due to the extensive use of machines in agricultural production. Both in agriculture and in manufacturing we seem to have distinct advantages in the invention, manufacture, and use of machines. These advantages have been commonly observed, but it should be noted that they count for much more in some industries than in others. Those industries for which machines have been invented, and to which the machine process is applicable, are likely to be among our most effective industries. It is equally true, though not so commonly mentioned, that those industries to which the machine process is not applicable or to which it is not so well adapted are likely to be our less effective industries, *i. e.*, industries in which we are at a comparative disadvantage.

One of the conditions which makes possible the employment of the machine process in manufacturing is a demand for standardized products. This is a necessary condition, for the function of the machine is to produce units of like products. If, in addition, this demand for standardized products be very widespread, much capital can profitably be invested in machines, for expensive machines can be used to produce cheap products, if they can produce enough of them, and if the whole output can be sold. Where these conditions exist the typical American industry can be employed. Such an industry is one of large cap-

ital, relatively little direct labor, and large output by each producing unit. It is commonly and expressively termed quantity production.

The advantage which the United States enjoys in this type of industry is further enhanced by the fact that American business men seem to be superior to foreign enterprisers in organizing and directing large numbers of workers. In fact, the high effectiveness of labor in the United States is probably due to a larger extent to the ability and vision of our business leaders, who organize and direct labor, and to our rich and varied natural resources, upon which the labor is employed, than to the native strength and mental alertness of the workers. Furthermore, as our industry develops along lines which leave less and less room for the employment of individual skill and judgment by the workers in manufacturing, a development which has been noticeable in the past two or three decades, the importance of the business and industrial organizer will become correspondingly greater.

It appears then that our greatest advantage lies in making machines and using these machines in the production of standardized products of considerable volume. This proposition is exclusive as well as inclusive. It excludes many of those industries in which a high degree of individual artistry is the most important element. For example, in the making of artistic designs for many products certain European countries have a comparative advantage over us. In those industries which require the constant attention of a large number of trained chemists or physicists the Germans seem to be not inferior to us. The ability and willingness to devote infinite care and attention to detail is again not our strongest asset. Likewise, we are not markedly superior to many foreign people in physical strength or endurance. Industries, therefore, in which these latter characteristics weigh heavily would seem to be those in which we suffer a comparative disadvantage, that is, our advantage if we have any, is likely to be less than in the industries employing machines and turning out large numbers of identical units.

Money Wages in the United States

Industries in which we have a natural comparative advantage will ordinarily develop here without specific government encouragement, or at least with no more than a temporary stimulus. Industries in which we do not have a comparative advantage often fail to take root, even with the encouragement of the government. Such industries may, indeed, be maintained by constant government assistance in the form of either a protective tariff or a subsidy. But if they are never able to stand unaided against the competition of foreign producers, that fact indicates that they are not industries in which we have a comparative advantage. For example, efforts have been made over a long period of years by our Department of Agriculture to foster the beet sugar industry in this country.[1]

It has been pointed out that the climatic and soil conditions in Michigan and other north central states are similar to those found in several foreign countries where sugar beets are successfully grown. The significant fact, however, is that the sugar beet industry is one in which a large amount of labor must be employed in proportion to the amount of machinery. It is, and apparently must remain, a hand industry. When growers look about for laborers they find themselves in competition with the factories and railroads and mines, which employ the same grade of laborers. But labor employed in these industrial pursuits is relatively more effective than in the sugar beet industry and, therefore, it is difficult to obtain an adequate labor supply. In fact, the growers profess that it would be impossible for them to hire laborers and conduct the industry at a profit, if they were not protected by a tariff on sugar, which enables them to obtain a price above that which would be fixed by the free competition of foreign producers. Another consideration which retards the growth of the sugar beet industry is the possibility of using the same land for the production of other products such

[1] *Cf.* Taussig, F. W., *Some Aspects of the Tariff Question*, Chapter VII. This whole series of essays is invaluable on the principle of comparative cost as applied to American industries.

as wheat and corn in which our relative advantage is greater. It is alleged that in Colorado and other western states natural conditions for this product are even superior to those of other countries, but again it is found that the demand of still more effective industries for the available labor supply prevents the development of the industry on a basis of free competition with foreign producers of cane and beet sugar.

The grower of sugar beets would very likely ascribe his inability to compete with foreign sources to the higher wages which he is forced to pay. His statement would be correct, but there would be no conflict with the explanation just given. The wages are too high for him, but why are they so high? Higher wages in this country than abroad are not due to fortuitous circumstances nor do they exist as part of the natural order. Rewards to labor and other agents of production are generally high only when the productivity of industry is high and the demand for the products of industry is great. The high wages, which the sugar beet grower finds an obstacle, are set by the competition of other industries, such as the manufacture of automobiles or the growing of corn or wheat. These industries have a greater advantage over foreign producers than does the sugar beet industry. They yield, at first, large profits; this leads to a demand for more labor, and this demand forces high wages. In these superior industries high wages can be paid without raising the prices of the products above the prices asked by foreign competitors. Here, then, we have the desirable combination of high wages, high productivity, and low prices. The higher wages set by these industries tend to raise the level of wages for workers of a similar type in all industries, including the sugar beet industry. But, whereas the automobile manufacturer can afford to pay wages higher than those paid by his foreign competitor, say twice as high, because his output per worker is twice or more than twice as great, the sugar beet grower finds that his superiority over the foreign producer is only 25 per cent and, therefore, a wage twice as high as that paid to foreign labor would be prohibitive. It is precisely through this adjust-

ment of wages that the supply of labor is directed into the most effective lines.

High wages, therefore, and high rates for the use of capital, the price of which is determined in much the same way as that of labor, will appear, if we adopt the point of view of an individual business man in a specific industry, as a handicap in meeting foreign competition. They will either lower the profits which he might otherwise make, or, if he be in an inferior industry, they may force him out of business altogether. Viewed, however, in a somewhat broader way, it appears, first, that these factors are the means of sifting out the relatively effective from the relatively ineffective industries, and second, that it is through these high rewards to the agents of production that the benefits of high productivity are diffused throughout the community.

That the same principle operates in low wage countries, with which the United States trades and with which it competes, is also clear. Japanese laborers may be less effective in all lines than our own, but this does not prevent them from exporting goods. The wage paid adjusts itself to the lower productivity. In some industries, say silk culture, it may appear that Japanese labor is perhaps 50 per cent as effective as ours, but their wage is only 25 per cent as great. That industry will be able to undersell its American competitors. In another industry, however, say shoe manufacturing, their producers may be only 15 per cent as effective as our own, while the wage is still 25 per cent as great as ours. In this industry they could not compete, and no doubt the Japanese employer would blame this to "high wages." Again it would be a correct, although a superficial explanation. From the point of view of the employer, therefore, the terms "high wages" or "low wages" for labor mean nothing unless they be interpreted in the light of the effectiveness of the labor. As explained above, this depends not only upon the laborer himself but upon all the conditions under which he works.

It will be seen from this reasoning that the fear of the competition of the pauper labor of Europe or of the Far East is baseless. We have as much, but no more, reason to fear the

competition of high wage countries, for the high wage is an indication of a high degree of effectiveness of labor, which enables the high wage to be paid, and the low wage is likewise an indication of an opposite condition, which forces the continuance of a low wage. The adjustment of wages between the several trading countries of the world has been made long ago, and no concern need be felt to-day regarding the ability of any country to sell its products in world markets, nor need we fear that the competition of the products of low wage laborers will demoralize the American standard of living. The existence of widely different wage levels in different countries does create a tendency for laborers of the low wage countries to migrate to the high wage countries. This cannot be put aside so lightly for it is a serious problem. The competition of the low wage countries is, however, a problem of the competition of the laborers themselves, not of their products.

The United States exchanges its goods for foreign goods on terms advantageous to itself. It will be recalled that a country gains most from international trade when the foreign demand for its products is greater than its own demand for foreign goods. But few countries are in a position to sell their products on such advantageous terms, even though they temporarily possess a monopoly advantage in the sale of certain goods. Several things are likely to happen to put an end to such an advantage. (1) The producers of the products in question are likely so to expand their production that the foreign demand, great as it may be, will be so fully satisfied that the price will decline. (2) If this is not possible with the existing supply of labor, workers from other countries, anxious to take advantage of the high incomes, will migrate to the high wage country. (3) Other countries are likely to discover or develop new supplies of the product.

The second possibility may be prevented by immigration laws, and, in any event, there are natural obstacles to it. The first possibility, and to some extent the third, can be avoided if a country possesses, not only a high effectiveness of labor and a favorable demand for its goods, but also a great variety of re-

sources to which it can turn as the yield of any one of them declines. The United States does possess such a variety of resources, and a comparative advantage is enjoyed in several industries. No one of the industries, therefore, is carried so far as to reduce greatly our advantage in exchange. In the growing of cereals, for example, production is not carried to such a point that foreign markets are flooded, because before this result occurs labor and enterprise are diverted to other lines in which we also have an advantage. Certain tropical countries, on the other hand, have a very marked advantage in the production of tropical fruits; but they fail to gain the full benefit of this advantage, because there are not alternative lines to whch they can turn when the supply of their products has satisfied the most urgent foreign demand.

The United States can obtain several kinds of goods from abroad, even from quite advanced countries, at a smaller cost in labor than is involved in the production of those products by the foreign producers. This arises from the facts that labor involved in the production of our export goods is highly effective and that there is a relatively great foreign demand for the goods which we export.

Factors Which Determine the Volume of a Country's Foreign Trade

A desire to increase the volume of a country's foreign trade is almost universal to-day, at least among the countries of European civilization. To this end chambers of commerce, banks, individual business men, and government agencies are bending their efforts. These trade-promoting agencies have their place, but it is well for the student of foreign trade to realize that some of the most potent factors determining the volume of a country's foreign commerce are not of this sort but are, indeed, much more fundamental. Such a realization need not be construed as a discouragement to these active efforts, but it should conduce to a better sense of proportion regarding them.

What are these basic factors which influence the volume of a

country's foreign trade? Since countries differ so much in size, there would be little point to a discussion of their total trade, but some of the factors which determine the volume of trade relative to the population may be noted. The first step in our inquiry is a statement of the actual foreign trade per capita of the several countries of the world. It will be well to keep this table before us in the succeeding discussion.

TABLE 1. THE ANNUAL FOREIGN TRADE PER CAPITA OF THE COUNTRIES OF THE WORLD.[1] Data for 1913. Values in dollars.

	TOTAL		TOTAL
1. Netherlands	$452.98	36. Spain	18.89
2. Belgium	221.47	37. Venezuela	17.58
3. New Zealand	191.26	38. Paraguay	17.19
4. Switzerland	168.26	39. Ecuador	16.44
5. Australia	149.39	40. Formosa	16.05
6. Denmark	139.82	41. Mexico	14.43
7. Canada	137.38	42. Honduras	14.31
8. United Kingdom	125.20	43. Turkey	14.01
9. Cuba	120.27	44. Bulgaria	13.25
10. Norway	101.58	45. Philippines	12.87
11. Argentina	100.39	46. Japan	12.80
12. Uruguay	94.47	47. Peru	12.78
13. Union S. Africa	84.44	48. Eritrea	12.10
14. Sweden	79.50	49. Guatemala	11.57
15. Chile	76.48	50. Salvador	11.44
16. France	74.98	51. Haiti	11.28
17. Germany	74.02	52. Colombia	11.20
18. Dutch W. Indies	63.37	53. Dutch E. Indies	11.19
19. Finland	54.16	54. Morocco	10.72
20. Panama	49.79	55. Greece	9.89
21. Costa Rica	46.24	56. Persia	8.74
22. United States	**42.60**	57. Russia	8.56
23. Italy	33.63	58. Serbia	7.95
24. Roumania	32.41	59. Siam	7.18
25. Tunis	32.31	60. French Indo China	5.91
26. Algeria	31.29	61. Lybia	5.80
27. British Colonies, N. E. S.	29.36	62. Sudan	5.43
28. Santo Domingo	27.23	63. French Colonies, N. E. S.	5.40
29. Brazil	26.43	64. Montenegro	4.90
30. Egypt	26.07	65. German Colonies	4.80
31. Bolivia	25.54	66. British India	4.14
32. Austria-Hungary	24.35	67. Chosen	3.36
33. Crete	22.91	68. China	2.15
34. Portugal	22.53	69. Liberia	1.68
35. Nicaraugua	19.54	70. Belgian Congo	1.47

[1] Based on data from Statistical Abstract of the United States. In a few cases, where data for 1913 were not available, those for 1911 or 1912 have been used.

The figures in the table on page 43 indicate the value of the total trade of the countries, *i. e.*, the sum of exports and imports, divided by the total population of the several countries. These values have been converted into dollars, and the countries are arranged in the order of the value of the foreign trade per capita.

The several factors which appear to influence the volume of a country's foreign trade will now be noted. (1) The most important factor is derived directly from the principle of comparative cost. A country's foreign trade will be relatively large if some of its industries have marked advantages over the others. Under this condition the superior industries will set a relatively high wage, which other industries will be unable to pay. Thus a high degree of specialization is effected, a considerable part of the country's products will be exported, and a considerable part of the consumption of the people must be provided for by goods imported. Alaska furnishes an extreme illustration, if we can, for a moment, consider it as a separate country. The combined exports and imports in 1900 amounted to slightly more than $800 per capita, a figure not even approached by any of the principal countries and about twenty times larger than the corresponding figure for the United States as a whole. The explanation obviously lies in the fact that Alaska finds its comparative advantage in very few products, and as a result the largest part of the country's produce is exported and almost all of the consumption is provided for by imports.

The United States, itself, furnishes an excellent contrast. There is found in this country an unparalleled diversity, as well as an abundance, of resources and a versatile population drawn from a variety of races to utilize these resources. As a result none of the major industries is at a distinct disadvantage as compared with the others. Or, to reverse the statement, none of the great industries has a sufficient superiority to attract laborers and capital away from the others. Thus we have, side by side, agriculture to produce the foodstuffs; manufacturing to produce clothing, shelter, and many conveniences of life; mines and forest industries to produce the raw materials for the manufac-

turers. Our trade has, therefore, been largely domestic rather than foreign. We are not self-sufficient, and perhaps we have gone too far through our tariff policy in attempting to live to ourselves alone, but quite regardless of any governmental policy this country would naturally have a relatively small foreign trade. If we look far enough into the future, we may possibly discern an increasing tendency to specialization in manufactures; but it is hardly conceivable that we shall ever look abroad for the principal markets for our products or for the principal sources of our consumption goods.

On account of this factor it happens that countries, large in area, are likely to have a smaller foreign trade per capita than have the smaller countries. Small countries are almost certain to find their greatest comparative advantage in relatively few products. Thus the four leading countries in the above table and most of the countries whose foreign trade per capita exceeds that of the United States are countries of limited area and resources.

(2) Another factor which makes for a large foreign trade is the high productivity of the industries of the country, compared to the industries of other countries. This relatively large productivity makes it possible for the inhabitants to produce and sell large quantities of their products and to obtain correspondingly large quantities from other countries. This absolutely high productivity likewise tends to produce a large domestic trade. It, therefore, does not cause a large foreign trade relative to domestic trade, but it does enhance the foreign trade per capita. This factor, no doubt, explains the fact that the United States stands as high as it does in the above list—that although its industries are more diversified than those of Russia or Brazil, its trade is nevertheless much larger.

(3) The factors mentioned have had to do with the conditions of cost of production. But conditions of demand likewise affect the volume of a country's trade. A varied demand makes for a large foreign trade, and such a varied demand naturally accompanies high incomes and a high standard of living. This, of

course, would be ineffective in the absence of a high purchasing power with which a command over these foreign goods could be obtained. But when accompanied by high productivity this diversified demand is an important factor in the foreign trade of the world. It explains, for example, the fact that many products of the same general class may be both exported and imported by a country. Wearing apparel, for example, is exported from the United States, but English and Parisian apparel is also imported. The latter goods differ, although perhaps almost imperceptibly, from the former. Such small differences can form the basis for trade if consumers' tastes are very discriminating.

(4) The intensity of the demand of foreign countries for the products of a country may materially affect the volume of its trade. Thus the industrial development of Europe, and particularly of the United Kingdom, has led to a large and inelastic demand for American foodstuffs and American cotton. Consequently, American purchasing power in foreign markets has been enhanced, and our imports as well as our exports have increased. The world-wide demand for nitrates and Chile's virtual monopoly in that product likewise have fostered the trade of that country. This factor should be borne in mind in connection with the factor of effectiveness of production. An effective industry is one in which the value of the product, proportionate to the amount of labor and other agents of production employed, is high as compared to other industries in the same country. But while the amount of physical product turned out by an amount of labor and capital is determined by conditions within the producing country, the value of that product depends also upon the conditions of demand both at home and abroad.

With staple products such as wheat, raw cotton, and lumber, the existence or nonexistence of a foreign demand is practically independent of any selling efforts on the part of the exporting country. But as regards the manufactured specialties, which are coming to play such an important part in the export trade of this country, a demand can virtually be created, or at least greatly stimulated, by active selling efforts. This demand creation may

be specific in its effect, or it may be intended merely to create a general feeling of good will toward the producing country and its products. In the effort to present the broad and fundamental principles of international trade little attention has been given to such sales tactics, but there can be no doubt that in specific cases foreign salesmanship and commercial diplomacy have played and do play a very important rôle. In a sense this is the most important factor for the individual business man; for, although it may not be as potent as some of the other factors mentioned, it is the one factor which is under his own control. As suggested at the beginning of this section, however, there is more danger that the American business man will be overly sanguine in his views of the efficacy of salesmanship, advertising, and government concessions, than that he will underrate them. Concerning the trade of the world at large, the direction and volume of that trade is largely determined by factors quite outside the control of individual business men.

(5) Cheapness and ease of transportation of goods to and from foreign countries likewise foster trade. The foreign trade of the United States and Canada is in both cases enhanced by the ease of transportation across the border. Even to a greater extent does this explain the large trade of Holland, Belgium, Denmark, Germany, France, and other countries of continental Europe with one another. In many respects this trade resembles our own interstate commerce, and although it is strictly speaking, "foreign" trade, the Europeans themselves often make a distinction between trade of this nature and their "overseas" trade. A country which is located far from foreign markets and foreign sources of supply is likely, other things being equal, to develop its domestic trade rather than its foreign commerce. Thus America's "splendid isolation" has had its economic as well as its political consequences.

(6) Custom duties affect the volume of a country's trade, at least for the time being, very much as do costs of transportation. Whether levied for protection or for revenue, and whether levied by a country upon its own imports or by other countries upon

their exports, they act as a drag upon international trade. Needless to say we are not yet ready to pass upon the justification of such measures.

It should be reiterated here that of these factors influencing the volume of a country's foreign trade, the various considerations concerning specialization of national industry are the most important. A country's foreign trade may be fostered by a paucity of some resources as well as by an abundance of others. This can be vividly illustrated by assuming a great national disaster which would wipe out the effectiveness of our agricultural industry. Our foreign trade might very well increase; for a large part of our foodstuffs would be imported, and the labor now used in producing these products would be employed in producing the products sent abroad to pay for our food. Our national production would be less, our consumption would have to be reduced, but our foreign trade would increase. We would be in the position of many of the countries which precede us in the above list. It appears from these considerations and from a study of the table given above that national prosperity is in no peculiar way dependent upon the volume of a country's foreign trade. For some countries foreign trade is truly essential, for others it is not. There is as much justification for strenuous efforts, encouragement, and propaganda for the development of foreign trade as of domestic trade, but no more. Trade consists of an interchange of goods and services whereby division of labor, and hence lower costs, are made possible. Trade, therefore, is good; but there is no special virtue in the international character of trade.

CHAPTER IV

ADVANTAGES AND DISADVANTAGES OF INTERNATIONAL TRADE

In preceding pages it has been remarked that the benefit which a people derives from its foreign trade is to be found ultimately in their imports and not in their exports. Exporting is important only as a necessary step in obtaining imports. This view of the relation of exporting to importing is a corollary of the proposition that trade is an exchange of goods for goods. The present chapter is devoted to a more specific statement of the advantages of international trade and a consideration of some of its alleged disadvantages.

Advantages

The business man interested in foreign trade is likely to describe its advantages in quite different terms than those employed above. To him exporting is all-important. It enables him to obtain wider markets, which, in turn, enable him to sell more goods or possibly the same quantity of goods at higher prices. That he should adopt such a view is perfectly natural, and from the point of view of the individual producer it is perfectly proper. This is, indeed, another example of a rather common phenomenon in economics, that the individual's motive in production or trade does not encompass the social benefit which, in a larger view, is the justification for his action. The business of the exporter is to export and to make a profit in so doing. The business of the importer is to seek a profit through importing. But the people as whole are neither interested in exporting nor in importing as such, but in getting desired goods for the least amount of effort. The student, therefore, and the manufacturer as well, if he really wishes to understand the system in

which he is playing a part, will do well to realize that the exports and the broader markets are merely means to an end.

It will be profitable to examine this relation of exports and imports in more detail. By means of the international exchange of goods we have at our disposal many products which practically we could not obtain at all if we were restricted to our own resources. These include articles of such common use as coffee, tea, cocoa, some kinds of tobacco, as well as many other goods which enter as raw materials into the numerous articles used by a modern civilized community. The benefit which a country derives on account of the import of such goods is one of the reasons that it is impossible to express quantitatively the gains from foreign trade, for this would involve the task of measuring the actual utilities derived by a nation from the possession of such goods as those named.

Other products, which could be produced at home, are obtained in greater abundance and with less effort by the international division of labor. The advantage of domestic trade in making possible an ever higher degree of division of labor and thus increasing the output of labor is here carried one step further and with similar desirable results. A development of foreign trade represents an extension of the area within which the territorial specialization of industry operates.

Industry in recent years has been marked by a tendency toward larger producing organizations. This offers certain definite advantages in manufacturing, but at the same time it increases the difficulty of marketing. The large plant must reach out to wide markets in order profitably to dispose of its products. Occasionally a plant can be enlarged to its most efficient size only by finding a market outside the country. This necessity does not arise as early in this country as in countries like England, Belgium, and France where the home markets are not so large. Our large and rich market will absorb a sufficient quantity of most products to permit the most economical scale of operation, and an increased foreign demand for certain goods may, therefore, merely increase the number of plants

producing those goods. In this event the foreign demand cannot be said to have made possible the utilization of the most effective size of business unit. References to the advantages of a large market often involve a confusion of an increased *number* of plants in those industries which cater to the foreign demand with an increased *size* of the operating unit—two quite different things.

An advantage in better application of our labor and capital may, therefore, result from this broadening of the market, but the advantage is not, as is so often stated, in the increased employment of labor. Obviously, the labor taken on by those plants producing for the export trade must be attracted from others. Unemployment is not explained by an inadequate number of industries in a country. If there were an oversupply of labor in this sense, new industries would arise, with or without foreign trade. The demand for goods on the part of the population of any country is always sufficient to absorb the total supply produced by that same population—provided, of course, the production is of the kind of products desired. The goods which, from one point of view, constitute a supply will be seen, when viewed from the other side, as demand.

This does not, of course, prevent recurring periods of "overproduction" and hence of unemployment, but these periods result, whether within a country or in the world at large, from wrong production, not from too large production all around. Now the regulation of production to foreign consumers' demands is beset with difficulties as great as (it sometimes seems even greater than) is production for the home market. England, with its very large foreign trade, has suffered much more from unemployment than has the United States, which is less dependent upon the foreign markets. It may still be argued that foreign demand for our goods is obviously an additional demand, and that as a demand for our goods is virtually a demand for our labor it must follow that more laborers would be demanded as a result of this new demand for goods. The obvious reply is that increased exports lead to increased imports, and that,

if the former increases the demand for American labor, the latter, by the same reasoning, must substitute a demand for foreign labor for the previous demand for American labor. As a matter of fact a development of foreign trade merely means that more labor is demanded for some industries and less for others. In England, for example, more labor is employed in manufacturing and mining and less in agriculture than would be the case if England had no foreign commerce.

It is nevertheless true that when a country has adapted its industry and its trade to an extensive foreign demand, any sudden diminution of that demand would be likely to cause unemployment. If this country, for example, were to be suddenly and absolutely isolated from all others, a revolutionary readjustment would have to take place both in production and consumption. Even after the readjustment our total product would be smaller, and real wages (wages in terms of commodities) would be much lower. But, the adjustment having been made, all labor would again be employed. In fact, because it would require more labor to obtain the goods which we are accustomed to consume, labor might be employed for longer hours than at present.

The only way by which the development of foreign trade might reduce the amount of unemployment would be by stabilizing the demand for goods. It might offset the seasonal or other fluctuations in the domestic demand for goods and thus make for a more steady demand for labor. Take, for example, an industry manufacturing summer wearing apparel. The demand in this country is highly seasonal; the demand in South America comes during our winter. If a manufacturer is catering to both markets he can keep his plant in operation for the full year. This is, no doubt, a desirable arrangement. It is desirable for the workers, in that it reduces the irregularity of employment. It is desirable for the manufacturer, in that it enables him to maintain economically a large investment in the business. This latter aspect is increasingly important, for the new type of industry, employing a large amount of fixed

and specialized plant and equipment and a large and elaborate organization of workers, can be operated profitably only when the demand is both large and steady. It is further alleged that a combination of foreign and domestic trade has also the effect of neutralizing the extreme fluctuations in demand from boom periods to periods of depression. It is a well-recognized principle of marketing that a wide market has an advantage in stability over a narrow market. Of course, no broadening of the market can protect a producer against such a world-wide depression as has followed the European war, but it is true that many disturbances are due to local crop failures or other forces which affect only one country or region. Against such depressions an established foreign demand is a sort of insurance.

Another advantage of the international exchange of goods is that it makes it possible for a "young" country, one which is in an early stage of economic development, to borrow capital from the "older" countries. International loans are, in fact though not in form, loans of goods, *i. e.*, they appear as exports of goods without necessitating at the time a corresponding import. This enables the country having the excess of imports to do one of two things: either to use the goods so imported for the building of railroads or other permanent equipment or to free a certain amount of its labor from production of the goods imported and apply it to the creating of the capital goods desired. This international borrowing was the characteristic feature of our early economic development, and it is now characterizing the national economy of countries such as China, Australia, and Canada. Conversely, the loan is repaid by an export of goods in excess of imports, and interest payments are likewise made in this way. Such a transfer of capital is advantageous to the borrowing country, because it thereby obtains funds needed for developing its industry, for getting its start, in other words. It is a benefit to the lending country in that it gives it a higher rate of return upon its capital than could be obtained at home.

It will perhaps strike some readers as strange that we do not

include among the advantages of foreign trade the possibility of disposing of our surplus products. This is the most popular argument advanced in this country in recent years in favor of expanding our foreign market. It is, however, purposely omitted. A moment's reflection upon the principles of trade set forth above will show that this argument, in so far as it applies to a long-time policy, rests on a misconception of the real nature of trade. It is true that, viewing a nation's industry at any moment, we may discover that it has been built up with a view to supplying both the domestic and the foreign market. In this case a continuation of the foreign trade upon which the industries have come to depend is necessary to prevent a very serious disruption of the economic system. But many speakers and writers who present this argument imply that this oversupply comes into existence of its own accord, and that after its production we have to find some use for it. This implication is hardly accurate. The large supply of goods which foreign trade takes off our hands has been produced for that foreign demand. That is to say, the foreign trade and the known opportunity of selling abroad were the causes of the supply. If suddenly all possibility of foreign trade should disappear, industry would adjust itself to different products—products which could be and would be sold here. As suggested above, that would be highly undesirable, but it would be undesirable because our industry would yield a smaller net return, not because a surplus of unsalable goods would continue to be produced. Thus any real benefit to the country that may be implied in this popular argument is, in fact, covered by our first-named advantage, the greater output and consumption possible under a system of territorial division of labor.

There are other advantages which may be termed moral by-products of international trade. Trade between two countries should lead and often does lead to close relationship in many other than purely economic lines. The trader is often the first missionary from one group to another, and upon the purely business relationship set up there may arise a better mutual

understanding, leading to an appreciation of the culture and civilization of different peoples. International economic relations thus militate against provincialism. The people of China were quite right in feeling that to admit the barbarian traders within the closed empire would ultimately lead to a modification of their traditional thought and culture. This breaking down of the bars of provincialism is, no doubt, a desirable feature of trading.

Possible Disadvantages

International trade, desirable as it may be when all things are considered, has its undersirable features. We now turn our attention to these. First we shall note another aspect of the non-economic factors mentioned in the preceding paragraph. International trade in the broadest sense of the term should lead to the establishment of friendly relations and thus make international conflict impossible. That it should have this effect would seem to follow from the fact that trade is mutually beneficial to buyers and sellers. That it does not do this, in fact that it frequently leads to just the opposite result, is due in part at least to two tendencies. In trade between a weak and a strong country, more particularly if the weak country is also a backward country, there is a strong temptation for the traders of the stronger country to abuse their economic power to obtain larger gains than would result from normal trade relations. Frequently they invoke the assistance of their own governments. This is bound to lead to ill-will, and very often the only reason it does not lead immediately to actual conflict is the weakness of the offended party.

But traders come in contact with foreigners not only in the relation of buyer and seller but also as competitors. This is a fruitful cause of international friction between great industrial states. For years before 1914 German and English traders had come face to face in their competition for trade in many parts of the world. The competition was most keen in the undeveloped areas. The report of this commercial struggle was heard "back home" and had its effect upon popular feeling and opinion both

in England and Germany. People take a peculiar interest in the financial success of their traders in the foreign field, an interest which is often absurdly out of proportion to any real economic stake involved. It becomes a matter of national pride, and when any question reaches this stage it ceases to be a matter for rational discussion.

Very often this straining of friendly relations is quite irrational, for it often happens, usually happens as far as European nations and America are concerned, that the trade of the contending countries with one another is much larger and more profitable than the trade of either with the district in dispute. Germany had a better market in England itself than she would have had in all South America even if English traders had been entirely forced out of that continent. Likewise, France was one of Germany's best markets, and Germany was more important as a market for French goods than any of the backward countries over which diplomatic battles were fought. Why should one rich community incur the ill-will of its best customer by quarreling over the relative proportions of goods which each sells to its poor neighbor? This, however, is merely to say that many of these commercial rivalries are unwarranted by the real importance of the stakes. It does not remove the fact that such results often do flow from a high development of international trade. This fact must be set down as a qualification of the desirable by-products of such trade. Finally, whether for good or for ill, any country which enters seriously into foreign trade, as foreign trade is conducted in these times, will find it very difficult to remain free from foreign entanglements. These need not be political in the first instance, but they strongly tend to become political in the end.

The chief objection of an economic nature offered to a development of foreign trade is the fact that it may, and often does, foster an extremely high degree of specialization. This is alleged to be undesirable for three reasons. (1) It makes a country dependent upon producers outside its borders for many of the goods and perhaps services which are essential to life and national efficiency.

In case of war with the countries supplying these essentials, the country's supply may be cut off. At any rate it is felt that a navy, large and powerful enough to protect supply lines, must be maintained. This in itself is a costly burden, and when we consider that the other countries with which war might possibly occur are also maintaining large navies, it will be seen that complete protection is impossible for all of them. With the new conception of war as a struggle between whole nations of people, not merely between military expeditions, this argument is of increasing weight.

(2) Another argument against extreme specialization has been advanced by a group of German economists. They were thinking, not of the danger of this dependence upon foreign producers in time of war, but of the danger that the foreign supplies might sometime give out and the industrial country be left without food supplies and raw materials. The argument runs as follows: Canada to-day can produce wheat and other foodstuffs at a lower cost than can German agriculturists. If the import of these products is unrestricted the German population will turn to manufacturing and cease the production of foodstuffs. But a larger population can be supported in a country when they are employed in manufacturing than when they are engaged in farming. This shifting of employment will, therefore, lead to a larger population. This is well, as long as the Canadians continue to produce wheat at low cost, but ultimately the population of Canada will increase; their free land will be taken up; they will turn to manufacturing, at least to such an extent that they will not have a supply of grain for export. This will mean that the now enlarged German population will have to be reduced through emigration or accept a reduced standard of living.[1]

While this argument has had considerable vogue in Germany, the danger of a country's being thus left without a source of supplies in time of peace seems to be unduly exaggerated. The Canadians would hardly shift from food production to manufac-

[1] For an example of this argument see selection by A. Wagner in Taussig, *Selected Readings in International Trade.*

turing unless there were some other country which could supply the world with foodstuffs at lower prices than could be maintained in Canada. If this other supply did not exist, a change in the type of industry in Canada would result in a lowering of the price of manufactured goods and a raising of the world price of agricultural products which would check the movement before it had gone far enough to endanger the food supplies of the industrial countries. There is a strangely persistent idea which is very generally held and upon which the above argument seems to rest, that there is a natural tendency of countries to progress from the agricultural stage to the manufacturing stage. This has been the tendency in the past but only because new food-producing areas have been constantly coming into the market. If the world ever reaches a condition in which all the new lands have been occupied and the supply of foodstuffs becomes scarce compared to the supply of manufactured goods, the prices of the latter will necessarily fall in terms of the former. Under such circumstances the present situation in which the manufacturing countries are the most wealthy and powerful would be reversed. Such a change is not at all inconceivable. But it would take place through the automatic working of supply and demand upon price and hence would come about gradually.

(3) A third argument against specialization points out the undesirable effects of a one-sided industry upon the social and political life of a people. It is often said in this country that a great body of small land-owning farmers constitutes the backbone and the conservative element of our national life. Whether this be accepted or not, it is certainly true that a very marked shift of the population from farms to the cities, from independent farm-owners to city wage-earners, would have a profound effect, whether for good or for ill, upon our social structure and national character. Such a shift in population would quite likely be accentuated by an increased foreign trade at a time when our comparative advantage is moving toward the production of manufactured goods. The extreme specialization of our southern states upon cotton production with its result of maintaining a

peculiar social system is in many respects unfortunate. This specialization has been made possible by the large outside demand, largely foreign, for raw cotton. It is quite possible that from a political and social and even from an economic point of view, the South would to-day be in a better position if it had been forced in years past to divert part of its production from cotton to other lines of effort. The protective tariff is often urged as a remedy for this condition. In this case, however, it would seem that nothing short of an export duty on cotton would have had the desired result.

As a matter of fact, a development of foreign trade does not necessarily involve such an extreme specialization as is here implied. Especially is this true where natural resources, climatic conditions, and types of population are varied. It is more dangerous in small countries in which the population and the physical resources are much the same in various parts of the country. These arguments against extreme specialization of countries are analagous to those advanced by Ruskin, Carlyle, and others, that the specialization of individuals in modern production has a deadening effect upon them. The answer to that argument must be in part the answer here; namely, that the benefit is to people as consumers. A greater variety of products for consumption, the purchasing power with which to buy these products, and more hours of leisure in which to enjoy these advantages, more than offset the undeniable disadvantages which the modern system places upon people as producers.

In summing up the arguments for and against an extension of a country's foreign trade, it will be seen that the chief arguments in favor of such trade rest upon the economic advantage gained by the trading countries. With a given amount of labor a country can obtain more goods by this roundabout method of production for sale than by the direct method of production for consumption. Opposed to this are arguments of undoubted weight based upon the effect of such trade upon our social and political life. Inasmuch as the principal arguments pro and contra fall in quite different categories, it is impossible for any one

person to decide between them, but they indicate that the whole question of the desirability of foreign trade has not been settled when we assert that more goods are obtainable for less labor through international specialization than through direct production.

CHAPTER V

FOREIGN EXCHANGE

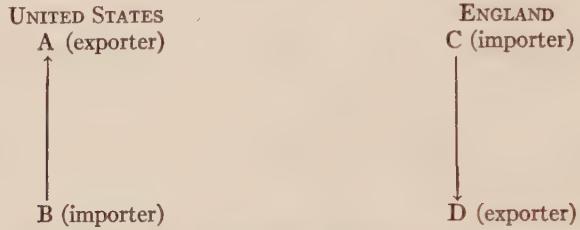
In the economic system with which we are familiar international transactions are conducted on a price basis. If we were dealing with countries as collective units trading with each other it would be quite possible to send a certain amount of wheat in direct exchange for a certain amount of cloth. In fact, however, we are dealing principally with certain individuals of one country selling to individuals of the other country. But the same principle operates. The goods and services received (imported) are paid for by goods and services rendered (exported). The problem of foreign exchange, then, stated broadly, is to explain how it comes about that transactions between individuals do, without conscious planning, lead to an equivalence of payment by and to the countries considered as groups.

The Nature of Foreign Exchange

How can the obligations of an individual importer be met by the export of goods by an exporter? This is brought about by the mechanism of foreign exchange. If A in the United States sells wheat to C in England to the value of $1,000, and at about the same time B in the United States buys $1,000 worth of cloth from D in England, it is apparent that the following credits and obligations are set up: in the United States, A is entitled to rereceive $1,000 and B is indebted for $1,000; in England, D is is entitled to $1,000 and C is indebted for $1,000, if we can imagine for a moment that the same monetary unit prevails in the two countries. Settlement might be made by a direct transfer of money:

United States		England
A ←	$1,000 in gold	← C
B →	$1,000 in gold	→ D

But the paper money of one country is rarely acceptable in another and the shipment of gold involves inconvenience, risk and expense. This would seem to necessitate two direct payments in some currency common to both countries—most probably gold. To avoid this inconvenience we might have settlement made between the American exporter and importer, on the one hand, and the English exporter and importer, on the other. Thus:



All parties would be satisfied. Fundamentally, this is what happens in the complicated operations of foreign exchange. Within each country the credit items of one group of citizens offset the debit items of another. What happens in case the one group of items does not exactly equal the other will be seen as we proceed. For the present we assume them to be equal.

The payments described above could be arranged by A drawing a draft upon C for the amount involved. B could then buy this draft from A and send it to D, who would collect his money by presenting the draft to C for payment. This could conceivably be done, but in practice it is open to at least two objections: (1) the importer B and exporter D who rely upon the draft drawn by A upon C might have some doubt that the draft would be honored; and (2) only by coincidence would two pairs of traders having transactions of exactly the same amount be known to one another. Now these two difficulties must be overcome, and as usual when the buyers and sellers of any commodity or service are not personally known to each other, middlemen arise to bring them together. In this case the middlemen are either private dealers in these drafts (bills of exchange) or bankers. The dealers could overcome the second objection by buying a

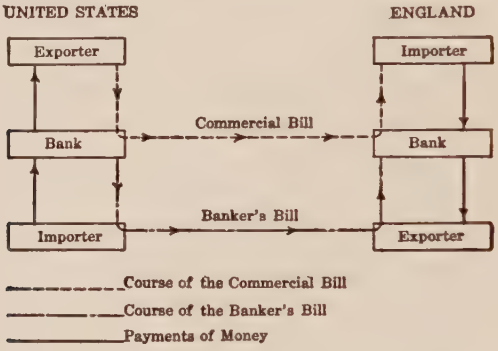
considerable supply of these bills and thus offering the buyers a wide choice. But they would not overcome the lack of confidence of the buyers of bills, for these bills would still be secured by unknown importers in England and exporters in the United States. The banks, however, can overcome both objections, and this is an important reason for their participation in foreign exchange.

A and the other sellers draw drafts upon C and the other foreign buyers of American goods. The banks buy these drafts and the American sellers are now out of the deal. They have their money from the American banks and are satisfied. The American banks use these drafts on Englishmen to build up a balance in English banks. That is, an American bank sends the drafts to its English correspondent bank, which collects them and holds the funds at the disposal of the New York bank. Thus, the New York bank creates a fund in the English bank against which it can draw at will. Now enters B, the American importer, who wants to send $1,000 to England. He comes to the American bank and for $1,000 (or thereabout) can buy from the bank an order on the English bank to pay $1,000 to D out of the fund previously established. B sends this bank draft to D, who obtains his money by presenting it to the English bank upon which it is drawn.

Certain Americans (in this case exporters) have by some previous acts obtained a right to demand payment from Englishmen. That is, they have control over purchasing power in England. On the other hand, other Americans desire to obtain and deliver purchasing power in England in settlement of some previous transactions (in this case imports of goods). The one group has at its disposal foreign purchasing power which it offers to sell for American purchasing power. This group (the exporters) thus creates a supply of foreign purchasing power, or, in other words, foreign exchange. The other group (the importers) desires to buy foreign purchasing power, and hence we say that they create the demand for exchange. The fact that the supply is immediately taken up by the bank and not

by the ultimate purchaser and that the demand is satisfied by the bank and not by the original producer of the foreign purchasing power should not obscure the fact that the relation between the amount of foreign purchasing power produced by the exporters and others and the amount demanded by the importers and others is the truly significant thing, and that the purchasing power used by one group is produced by the other.

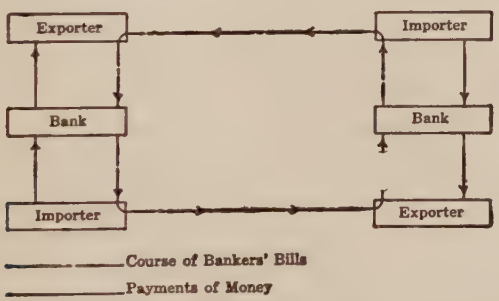
The relations between the traders and the bankers and between the commercial bills (drawn by the traders) and bankers' bills (drawn by the banks) can be illustrated in the following manner:



Now notice the flow of actual money or other evidences of domestic purchasing power in the two countries. In each case it flows into the banks from the importers and out to the exporters. Any scheme whereby the importers pay funds into the bank to be paid over to the exporters can be utilized. It probably has occurred to the reader that different methods were employed in the settlement of the two transactions in the above illustration. The American exporter drew upon the English importer, but the American importer remitted to the English exporter. That is, Americans took the initiative in both cases, and English purchasing power was made the basis of both transactions. This plan was used for the purpose of simplicity and, in fact, it is, between the countries selected, a very common procedure. But the importers in each country might have

remitted bank drafts to the exporters in the other country.[1] This would satisfy the essential requirement that importers in the two countries should pay funds into their banks and exporters draw these funds from the banks. In this plan the commercial bill need not appear at all. An American bank permits an English bank to draw drafts upon it for the financing of our exports. These drafts are sold to English importers who send them to American exporters in payment for goods. The American exporters collect their money from the American bank. By this transaction the foreign account of the American bank has been augmented and its funds in this country have been depleted. A flow of funds in the opposite direction, into the American bank and out of its foreign balance, results from the sale of bank drafts to American importers and their collection by English exporters. Again, it is seen that American and English exporters, respectively, supply the foreign funds or foreign exchange, which is sold for domestic funds offered by the importers. By this dual exchange system exports of a country pay for the imports of that country.

The relations of the several parties when each importer remits a bank draft can be illustrated in the following manner:



It thus appears that whatever technical methods be employed, the system of foreign exchange amounts to an exchange of foreign purchasing power for domestic purchasing power. The ratio at which these exchange is the rate or price of exchange. For-

[1] Which of the two plans will be employed in practice depends upon the terms of the contracts of sale which, in turn, are influenced by a number of factors discussed in Chapter IX.

eign purchasing power is ordinarily expressed in terms of the monetary unit of the foreign country and domestic purchasing power in our own monetary unit. Thus the rate of exchange is expressed as a ratio between two monetary units as, for example, so many dollars per pound sterling or per mark or per franc, as the case may be.

Factors Determining the Rate of Exchange

Now the price of this foreign purchasing power will depend upon the supply of it controlled in this country and offered for sale, on the one hand, and the demand for it, on the other hand. If the merchandise exports from this country to England have been large and, therefore, Americans control a large number of English pounds sterling, and at the same time imports have been small and therefore the demand for pounds sterling with which to make payments in England is small, the price in this country of these units of English purchasing power will be relatively low, say $4 equals one pound. This is true because the market for foreign exchange is highly competitive and homogeneous. The title to pounds sterling must be disposed of, for only in this way can the exporters and others obtain purchasing power which is of any use to them. The price, therefore, declines to a point at which the total supply of pounds sterling will be disposed of for dollars. If, on the other hand, the imports from England have been large and, therefore, the number of dollars offered for pounds is also large, while exports to England and, therefore, the supply of pounds available is small, the price will be high, say, $6 equals one pound. The price will so adjust itself as to make the total of domestic purchasing power offered by the importers (and others who are indebted to foreigners) just equal in value to the total of *foreign* purchasing power offered by the exporters (and others entitled to receive payments from abroad).

This would seem to make possible an almost unlimited range of prices of foreign exchange, and at times this is almost literally the case. There are certain checks, however, which retain this

price within bounds and, in normal times, when the currencies of the trading countries are based upon gold, there is a force which places very definite and narrow limits upon such variation in price. We, therefore, turn to these checks upon the exchange rate under such conditions as prevailed before 1914, *i. e.*, an almost universal gold standard currency and a free flow of gold from country to country.

Under such conditions the gold content of the monetary unit of one country bears a very precise relationship to that of the monetary units of other countries. This gold content is fixed by law in the several countries and thus is not subject to constant fluctuation. For example, because of these legislative enactments, there is 4.8665 times as much gold in the pound sterling as in the dollar. We, therefore, say that the ratio, $4.8665 = £1, is the gold par or mint par of exchange, meaning that the gold of the English pound sterling would be worth, at a United States mint, $4.8665.

Now to return to the rate of exchange. If the rate of exchange, or the price which the importer is asked to pay for control over pounds sterling, rises sufficiently above the mint price or the gold content of the pound to cover costs of transportation in sending gold to England, it would be to the advantage of the importer to obtain actual gold here and ship it abroad. On the other hand, if the rate falls sufficiently, exporters will find that it will be more profitable to have gold shipped to them from England than to accept such a low price in dollars for their title to pounds sterling. In practice, such gold shipments are made by bankers instead of by traders. The price of exchange which is just high enough to induce an outflow of gold is called the upper gold point. The price which is just low enough to bring about an inflow of gold is the lower gold point. In 1913, these points were, as regards sterling exchange, $4.88½ and $4.84½ per pound sterling. The gold points are determined by the mint par of exchange plus or minus (as the case may be) the cost of transporting gold.

A rate of exchange as high as the upper gold point would have

been due immediately to the fact that the foreign funds of the bank, against which bank drafts can be sold were small relative to the demand for such drafts. The bank will be anxious to sell drafts at the high prices prevailing. It may, therefore, ship gold abroad to augment its foreign balance. The importers actually use bank drafts as before, but now the drafts are balanced by gold shipments from this country instead of by merchandise exports. Likewise, the lower point will lead banks to reduce their foreign balances, and build up their domestic funds by drawing gold from abroad. Thus, when gold is freely obtainable, the rate of exchange is normally held within rather narrow bounds.

But this movement of gold is not likely to continue indefinitely for it, in turn, affects the profitableness and hence, normally, the volume of merchandise exports and imports. If other factors remain substantially unchanged, an increase in the supply of gold within a country lowers its value, which is another way of saying that it raises prices, and a decreased supply of gold has the opposite effect. Therefore, gold imports, if long continued, raise prices and make the country a poor place in which to buy and a good place in which to sell. This stimulates imports and discourages exports. This in turn increases the demand for exchange and decreases the supply and thus the rate rises high enough to stop the outflow of gold and to bring the imports and exports into balance again. The opposite tendencies follow from an outward flow of gold. To recapitulate: An excess of merchandise exports leads to a low rate of exchange; the low rate leads to an import of gold; this, if carried far enough, leads to higher prices; higher prices encourage imports and discourage exports. Thus an unbalanced trade tends to right itself when gold is available for export and import.

While the reader may grant the theoretical validity of this analysis, he may be inclined to doubt if such a chain of causation would actually be effective. As a matter of fact, this check to an unbalanced trade is more often potential than actually effective. That it will be effective if the flow of gold proceeds

far enough there can be little doubt,[1] but ordinarily a relatively small movement of gold, much smaller than would be necessary to affect the general price level of the country, will be sufficient to serve the purpose. The inflowing gold enters first the reserves of the large city banks; this makes possible an expansion of credit at low rates to speculators and other traders in the great international products, such as wheat and cotton, and also securities. This temporarily enhances their prices, and, as their movement from country to country is very sensitive to even slight variations in price, this advance in price is likely to result in lessened exports of some and increased imports of others. Thus the balance is reëstablished with no effect, or a very slight effect, upon the general price level.

Another check to an unbalanced trade is to be found in the rate of exchange itself. When exports are overly large the rate of exchange declines. This in itself makes exporting less profitable and thus tends to reduce its volume. But a low rate of exchange is favorable to importers, for they pay less than before for the foreign purchasing power needed to obtain their goods. Likewise to take the opposite case, excessive imports create such a demand for exchange that rates rise and this, in turn, checks the imports and encourages exports. If it were not for the limits set by gold shipments noted above the exchange rate itself would rise or fall by so much that it would directly correct any lack of balance. When gold shipments are possible such exports and imports of gold supplement the merchandise exports and imports, respectively, and thus effectively prevent a very wide variation in exchange rates. Within these limits, however, the direct force of the exchange rate operates to the same end as does the flow of gold.

We see, therefore, that the exchange rate and trade each appears mutually as both cause and effect. The exchange rate results from the relative volume of exports and imports, which give rise to supply and demand for exchange. But the

[1] Something very similar to this happens in the case of gold-producing countries, *e. g.*, the United States from 1848 to 1873, *cf.* p. 89, *infra*, and Australia in the middle of the last century, *cf.* Cairnes, *Essays in Political Economy*, pp. 20–49.

exchange rate also influences the volume of exports and imports. This is quite consistent with the general principle of price. The supply and demand of any commodity or service determines its price, but that price, in turn, is an important factor in controlling the supply of the product or service and the demand for it.

Prices and Exchange Rates

Up to this point we have assumed a free flow of gold from country to country and that the several countries involved in trade were either actually using gold as a medium of exchange or, at least, that their currencies were based upon gold. This condition prevailed for the chief trading countries in pre-war days, but as a result of disturbances growing out of the Great War the currencies of many countries to-day bear no constant relation to the value of gold which their monetary units purport to represent. The volume of paper money has been very greatly increased, and its free exchange for gold has been discontinued. In some countries this is probably only temporary, but for others there seems to be no possibility that the vast amounts of paper currency can ever be made freely convertible into gold, at least at the old ratio. This has had a profound effect upon the rates of foreign exchange. Thus whereas it was stated above that when gold was available for export and import the rates of exchange between two countries could fluctuate only within very narrow limits—the upper and the lower gold points—we now find that the rates of exchange fluctuate widely, bearing no relationship to the old par of exchange. Does this not completely invalidate our conclusions concerning the effects of trade upon the rates of exchange and of the exchanges upon trade? Not completely; somewhat similar results obtain, but there are new and disturbing factors to be considered.

In order to see what changes are wrought by an inconvertible paper currency, let us consider the case of trade between two countries which were first upon a gold basis and one of which later changed to a paper currency. Suppose that these two

countries are Germany and the United States, and that the mint par of exchange was 4 marks = 1 dollar. That is, the gold content of the mark and the dollar was as 1 to 4. Further, we assume that gold and paper money were freely interchangeable in both countries and that gold was freely available for export and import.

Because of the free flow of gold and goods between the two countries, a certain amount of gold would exchange for the same amount of goods in both the United States and Germany—at least the same amount of those goods which commonly enter into international trade. Now, as we have assumed the gold content of the dollar to be 4 times as great as that of the mark, trade between Germany and the United States would be in equilibrium when the dollar purchased four times as much of exportable goods in the United States as the mark purchased in Germany. That is, a condition of equilibrium [1] is attained when the monetary units of the two countries exchange for one another in a ratio which corresponds to the purchasing power of the two units in their respective countries. If this condition did not obtain at any time, if, in fact, the gold mark would purchase in Germany only one-fifth as much of goods as the dollar would purchase in the United States, while the mark contained one-fourth as much gold as the dollar, the mark would be undervalued in the purchase of German goods as compared with its power in purchasing American goods. Gold would, therefore, flow from Germany, where it was undervalued, to the United States in exchange for American goods. This would readjust the relative values of gold and goods, prices declining in Germany, *i. e.*, the value of the mark rising, and the opposite movement taking place in the United States, until the normal relation of the value of the mark in Germany and of the dollar in the United States was again attained. Or if, on the other hand, the purchasing power of the mark in Germany were one-third

[1] By a condition of equilibrium we mean such a relation of exchange rates and prices as will lead to an approximate equality of exports (visible and invisible) and imports (visible and invisible) in both countries. Such a condition can persist indefinitely; any other condition tends to destroy itself.

that of the dollar in the United States, the mark would be overvalued at home and gold would flow from the United States to Germany in payment for goods shipped from Germany to the United States. Consequently, a decline in prices would result in the United States and a rise in prices in Germany, until the balance was again attained.

Thus, because of the ease of transporting gold and its general use in the two countries, an adjustment of trade would be easily maintained. Goods and services rendered by one country would offset those received from the other. The stimulus to exports generally would be as great as the stimulus to imports, but no greater. The exchange rates would remain very close to the mint parity, varying above or below it only by the small amount which would cover cost of transportation of gold from one country to the other.

It should be noted that the equivalence of purchasing power of similar quantities of gold in the two countries is limited to their purchasing power applied to those goods which are transferable from one country to the other. We can call these international goods. When gold is available for export and import the average of the prices of all these international goods must be about the same in all the trading countries. The prices of some goods will be higher and of others lower than in other countries to such an extent that the stimulus to exports is about equal to the stimulus to imports. But there are other goods which in their nature must be produced and consumed within the same country. Houses are an example. A certain quantity of gold need not buy the same amount of these goods in two countries. In fact, it usually does not. It is, of course, true that the prices of the international goods and services affect, in the long run, all prices and wages, but the relationship is not immediate.

Exchange Rates Under Paper Money

Now let us assume that one of the two countries, say Germany, departs from the gold basis for its currency, while the United States retains the old standard of value. When any country

enters upon a program of issuing paper money which is, in fact, not freely convertible into gold, and this issuance of money proceeds more rapidly than the increased trade of that country, two results are likely to follow: (1) the general price level of the country advances, and (2) there appears a divergence between the value of gold and the paper money which no longer represents that gold. The first result is generally apparent, although it may be very difficult or impossible to measure it accurately. The second may possibly not appear at all in the domestic trade, because the gold may have been withdrawn from circulation either by hoarders or by the government or banks for use as a reserve. It appears promptly, however, in the foreign exchange rates between this country and gold standard countries, for here we have a comparison of the paper money with gold.

Suppose that as a result of Germany's fiscal policy prices rise to a point at which it requires, on the average, 8 marks to buy the same quantity and quality of freely transportable goods which were previously valued at 4 marks. Suppose, further, that the price level in the United States has remained unchanged. Exchange rates in Germany will also rise—normally to 8 marks = 1 dollar. They will rise to something like this level because this represents the ratio of purchasing power between the two monetary units. More specifically, the exchange rate could not well remain at 4 marks = 1 dollar, because if it did American buyers of German goods would find that, although German prices had doubled, they still had to pay as much as before for their marks. This would check their purchases and, therefore, the demand for marks on the part of American importers would seriously decline. This would force the sellers of mark exchange to offer more favorable terms, *e. g.*, first five marks for a dollar, then six, then seven, and finally eight marks. This tendency would be accentuated by the fact that the supply of marks offered on the New York market would not only remain as large as before, but would increase. This would be true because American exports to Germany would be stimulated by the rising prices there and the stationary prices here. American exporters, therefore, de-

siring to dispose of their command over marks for actual dollars, would have to offer more marks for a dollar until they offered eight marks for one dollar. The same forces can, of course, be viewed from the point of view of the other country. If, when prices in Germany had doubled, the exchange rate remained at the old level, the German trader would find that marks would purchase more when used to buy dollars and the dollars used to buy American goods than when they were used at home. He, therefore, would demand dollar exchange, and this demand would advance the rate of exchange until he would be paying eight marks for a dollar. Then the unusual demand would slacken and the supply of dollar exchange at this price, created by German exports, would just satisfy the demand for it on the part of the importers.

If the dollar exchange rate in terms of marks has advanced, as in this case, by an amount which just measures the advance of prices in marks over prices in dollars, a new equilibrium will have been established. It is properly termed an equilibrium because (1) trade can be carried on indefinitely as long as the price levels and exchange rate remain unchanged; and (2) if one of the factors changes, the other remaining constant, corrective forces operate to reëstablish the old relation. This is what we mean by an equilibirum.

Not only is this a new equilibrium but, if it is attained, it is, for the time being, as truly "normal" as was the old equilibrium of 4 marks = 1 dollar, which existed when both countries were on a gold standard. There is no force in the economic mechanism tending to reinstate the old mint par of exchange. There is a common opinion that the present exchange rates are abnormal and that in due time the old rates will, or at least should, return. They may indeed return in some countries, but if they do it will be by a very drastic deflation induced by governmental or concerted banking action, which would be as truly arbitrary as was the issuance of paper money and the inflation which brought about the present situation.

The facts have not been as simple as this. American prices

have not remained stationary, but they too have risen, though not so much as prices in Germany. The principle stated above, however, is not affected by this. The exchange rate which tends to be established is one which will be proportioned to the relative purchasing power of the two currencies, each within its own country. Thus, if trade was in equilibrium in 1914, with exchange rates at 4 marks = 1 dollar, but since then American prices doubled and German prices quadrupled, then marks should, under the new conditions, exchange for dollars in the ratio of 8 to 1. Under these conditions trade could continue as before, for prices and exchanges would have moved together; the depreciation of the mark compared to the dollar in foreign exchange would be just equal to its depreciation in purchasing power in its own country.

Purchasing Power Parities

Some notion of the extent to which these adjustments between internal prices and the exchange rates have actually been brought about can be gained from the following table. The data upon which the computations are based are not entirely satisfactory. The results, especially for Germany, are necessarily only approximately correct. Even so, however, they serve to illustrate the points under discussion.

TABLE 2. PARITY OF PURCHASING POWER AND RATES OF EXCHANGE.[1]

Dates	England		France		Germany	
	Parity of Purchasing Power	*Rate of Exchange*	*Parity of Purchasing Power*	*Rate of Exchange*	*Parity of Purchasing Power*	*Rate of Exchange*
			cts.	*cts.*	*cts.*	*cts.*
1913...	$4.86	$4.86	19.3	19.3	23.8	23.8
Jan., 1919....	4.32	4.76	11.0	18.3		
July, 1919....	4.27	4.43	11.8	14.4		
Jan., 1920....	3.94	3.69	9.2	8.5	5.200	1.690
July, 1920....	3.92	3.86	9.3	8.1	3.980	2.530
Jan., 1921....	3.56	3.74	8.1	6.4	2.520	1.550
July, 1921....	3.68	3.63	8.2	7.8	2.220	1.300
Jan., 1922....	4.30	4.22	8.5	8.2	.782	.520
July, 1922....	4.80	4.45	9.1	8.2	.264	.200
Jan., 1923....	4.95	4.65	7.7	6.7	.005	.007

[1] The parity of purchasing power is determined in this table by the following method: $\frac{\text{Index of American prices}}{\text{Index of foreign prices}} \times$ par of exchange = parity of purchasing power.
Thus for January, 1919, the English index number was 224 (1913 = 100) and the American index was 199 (1913 = 100). Therefore,
$\frac{199}{224} \times \$4.86 = \$4.32$ purchasing power parity of £1.

The conception of purchasing power parities, as applied in this table, perhaps requires further explanation. We assume that in 1913 £1 would purchase, in England, exportable goods approximately equal in quantity and quality to those which could be purchased in the United States for $4.86. Specific goods would, of course, be higher in price in one country than in the other: if they were not, trade could not have taken place. But a composite lot of international goods, including those commonly exported and imported, which could be bought for £1 must have been worth, in the United States, about $4.86. This seems to be a reasonable assumption; for if it had not been true, gold would have been overvalued in the one country and undervalued in the other, and only one-sided trade could have existed. But during the war there were radical price changes in both England and the United States, and the free flow of gold was prevented. By January, 1922, English prices had advanced so much more

than American prices that it appeared that the purchasing power of £1 in England was about equal to the purchasing power of $4.30 in the United States. Now, if this relation of prices persisted for some time, and if the forces described in preceding pages of this chapter had been permitted to operate freely, we would have expected the exchange rate to settle at $4.30 = £1. That is, under these conditions, the normal exchange rate would have been $4.30. Had this rate actually existed, normal two-sided trade could have existed as it did under the conditions of 1913. American buyers would have found that they had to pay more pounds for goods bought in England than they did before; but this would have been offset by the lower price of pounds in the American market, *i. e.*, the lower exchange rate. In fact, the rate of sterling exchange in New York in January, 1922, was $4.22. This gave an advantage to Americans importing from England and was a disadvantage to Americans selling to England. But, for the purpose of measuring the advantage or disadvantage arising from exchange rates, a comparison of the existing rate with the pre-war rate would have no significance. The proper comparison was of $4.22 with $4.30, not with $4.86. The French parity, in January, 1923, was 7.7 cents, while the exchange rate was 6.7 cents, both having dropped from 19.3 cents in 1913. Even the radical changes of the German monetary system have permitted an approximate adjustment of exchange rates and prices—at least down to the point where the value of the German mark approached so close to zero that even approximate comparisons were made impossible.

These experiences illustrate a conclusion reached above: that changes in the price levels and in the rates of exchange tend mutually to offset or balance one another, so that a country neither gains nor loses as much in international trade as it would if either of these factors operated alone. Thus German exporters in July, 1922, did not have the advantage which would seem to be indicated by the fact that it was possible for American importers to buy one German mark for approximately .20 cent. This advantage was largely, though not entirely, offset by the reduced

purchasing power of the mark. If the rate had been as high as .26 cent they would have had no advantage at all. Whenever the exchange rate (expressed in dollars per unit of the foreign money) is lower than the purchasing power parity, the external value of the foreign currency is less that its internal purchasing power and exports from that country to us will be encouraged. When the exchange rate is above the purchasing power parity the external value of the currency is greater than its domestic value and imports into that country will be encouraged.

The preceding discussion seems to indicate that a depreciated paper currency is not such a serious obstacle to the conduct of normal international trade as it is sometimes assumed to be, for the rates of foreign exchange tend to adjust themselves to the higher prices and to offset the effects of those prices. This adjustment, however, requires time and the rate of movement of the exchange rate may be quite different from the rate of movement in the price levels. If, therefore, paper money is being issued periodically, the rate of exchange, being very sensitive, may react promptly with each new issue, or even in anticipation of expected issues, while the general price level may lag behind the currency changes. Then at any stage in this process the exchange rate in Germany, to follow our previous illustration, may be very high, *i. e.*, a large number of marks exchange for a dollar, while prices in Germany have not advanced proportionally. This is a source of added profits to German exporters, who may either retain the profits or, if they find themselves engaged in close competition in the foreign market, cut their prices below those which could be offered by foreigners. To view the same situation from the American side, our importers obtain many marks for a dollar and although they find German prices higher than before they may not be so high as to offset entirely the low price of marks. This gives the German exporter an unusual advantage. This supposed case very much resembles the actual course of German trade since the war.

The point stressed here is that the advantage to German exporters lies not in the rate of exchange *per se* but in the fact that

the progressive issuance of paper money has prevented the exchange rate and prices from maintaining a parity. Further, the ordinary forces of supply of exchange and demand for exchange induced by exports and imports, respectively, are at work even in these changing currents, although at the moment changes in the money supply may be more effective in determining exchange rates. If the amount of currency in the two countries should remain stationary for some time, the chief obstacle to establishing a stable rate of exchange and normal trade would be removed. The chief obstable, but not the only one. In arguing that trade on a paper basis need not be utterly chaotic, some writers seem to go to the opposite extreme, implying that this form of currency can be made to serve the needs of international trade quite satisfactorily, if only the amount of currency remain stationary. But even then there would be changes in money values from political disturbances and other factors than the quantity of money. The checks and balances to international trade which maintained such stable commerce as existed before 1914 cannot, practically, be reinstated until some definite relationship between the paper currencies and gold has again been set up.

CHAPTER VI

THE BALANCE OF TRADE

We now turn to a consideration of the balance of trade, a subject which is intimately associated with the principles of foreign exchange, so much so, in fact that some aspects of the subject have necessarily been introduced, by implication, in the preceding discussion. The subject, however, is of such fundamental interest in the principles of foreign trade that it deserves special consideration.

The term "balance of trade" is employed in two quite different senses. First, it refers to the principle of equivalence of values of payments by a country and payments to that country. The goods, services, and other values received by a country in a period of time must be paid for by an equal amount of goods, services, and other values rendered by that country, or, more briefly, the payments to a country must be balanced by payments by that country. This is the principle of the balance of trade. On the other hand, the term is commonly applied in financial circles to the amount which remains to be paid on account of a disparity between merchandise exports and merchandise imports. It is in this sense that we meet with the terms "favorable" and "unfavorable" balance. The balance of trade is said to be favorable when exports of merchandise exceed imports and a balance is, therefore, due to the country, and unfavorable when the opposite relation of exports and imports prevails. A more appropriate designation would be the "merchandise balance of trade." When we view all the transactions of any country, there is normally no balance remaining, in the sense of a net amount due to or from a country; but when we consider only merchandise transactions a balance one way or the other is not only possible but is, in fact, most common.

Credit and Debit Items

In our discussion of foreign exchange we considered only two types of international transactions: merchandise exports and imports, and transfers of gold. The other international transactions to be noted are similar to either exports or imports in their effect upon international indebtedness. With this similarity in mind they are often designated as invisible exports or invisible imports. In the following discussion, however, we shall classify them as either credit or debit items. In using these terms we are visualizing an account of every nation with all other nations. Some items call for payments by that country; others, for payments to it. The former are debit items; the latter, credit items. Merchandise exports, for example, represent values rendered by a country to foreigners, which call for payments to the country whose point of view we have assumed. They are, therefore, credits and ordinarily, though not necessarily, the most important item of this class. Merchandise imports, likewise, constitute the most important debit item. If trade were carried on by barter between primitive communities, with no other possible transactions, an equivalence of values would normally be maintained between these two items alone. In our modern world there are many items, which may offset an excess of one of these merchandise items over the other.

A shipment of gold to foreign countries constitutes another credit item, while an import of gold is a debit item comparable to merchandise imports. Under a partially developed commercial system wherein gold was, aside from commodities, the one generally accepted good, discrepancies between the merchandise transactions would likely result in shipments of gold. This was commonly true among the European countries during the later Middle Ages. But, with the development of modern business, other items have come into prominence which are, in fact, much more sensitive to the requirements of international payments than gold. Compared with the highly refined methods of settling international balances, the shipment of gold is a clumsy and expensive expedient.

A common method utilized for settling short-time discrepancies between the other items is borrowing and lending of bank credit between banks. Suppose, for example, that during the summer months our imports and other debit items exceeded the exports and other credit items but that there was a prospect of large exports of agricultural products in the fall months. This situation would lead to a present demand for exchange, *i. e.*, for foreign purchasing power, on the part of the importers. Rates of exchange would be high. In order to satisfy this demand, American banks or other dealers in exchange might ship gold and draw against the account thus built up abroad, as described above, or they might make arrangements with a foreign bank, whereby that bank would agree to honor ninety-day drafts drawn upon it. This arrangement enables the American banks to draw foreign drafts, selling them at a favorable rate and satisfying the importers' demands for foreign purchasing power. Now within ninety days American exports increase as anticipated, and the price of exchange, therefore, declines. The American banks can now purchase exchange at a low price and meet their obligations with the foreign banks. Thus the imports of one period are made to balance the exports of a later period. From one point of view, this is a mere speculation in exchange, but this speculation serves as an expedient for bridging the gap between a period of large imports and one of large exports and for maintaining a more nearly uniform price of exchange. The original transaction, coming at a time when exchange rates were abnormally high, made them somewhat lower than they would otherwise have been, and the final settlement, at a time when rates were abnormally low, made them somewhat higher. Such is the usual effect of intelligent speculation in any market. It should be clear that the device outlined is a temporary one and cannot be utilized to offset a merchandise balance which is consistently running against a country.

Another item of considerable importance is securities commonly bought and sold on the stock exchanges of the principal countries. Thus, if our exports and other credit items exceeded

the debit items, the balance might be maintained by transferring certain well-known securities to the creditor country. This transfer is facilitated by the ease with which such securities can be transported, by the convenience of obtaining and disposing of them, which is insured by the fact that a considerable purchase and sale of these securities is constantly in process on the leading exchanges of the world, and further by the fact that their values at any moment are easily ascertainable on these exchanges. These characteristics are not, of course, found in all securities. The sale of many securities would involve a careful examination by the foreign buyer and perhaps some persuasive effort on the part of the seller. But government securities and many securities of well-known railroads and some industrial corporations, enjoy a free and continous cash market in several trading countries. The buying of such securities acts as a debit item to a country and their sale as a credit item, thus offsetting merchandise or other transactions of the opposite nature. This transfer of generally acceptable securities may be only temporary, designed to take advantage of a temporary condition of the exchanges. The securities may, in fact, not be transported at all but only held for the account of the purchaser, who may shortly sell them again when the exchanges have altered to his advantage. This international ebb and flow of securities is distinguished from foreign investments proper, in that it is largely temporary and that the principal motive is to take advantage of the rate of exchange rather than to earn the interest or dividends from the securities.

So far we have dealt with credit and debit items other than merchandise exports and imports on the assumptions that discrepancies between the merchandise items were merely temporary and that the relation between these merchandise items would, in a comparatively short time, reverse itself, and thus that over a period of a year or more the balance would be maintained without including these so-called invisible items. The trade of most countries, especially those exporting agricultural products, is more or less seasonal and these minor fluctuations are common.

But, on the other hand, there are other discrepancies between these merchandise items which are more long-lived. Thus England since the middle of the last century has had imports in excess of its exports and the United States since 1874 has had an excess of exports.

Such a permanent merchandise balance may be offset by shipments of gold, provided the gold-exporting country is a producer of gold bullion. Gold shipped on this account will not have the effect of lowering prices in the country. It should, in fact, be considered as a part of the merchandise trade as distinguished from shipments of gold which represent a net deduction from the money supply of the country. In gathering statistics of trade, however, it is impossible to distinguish gold from one source or the other and hence, more in appearance than in reality, we have a separate credit item.

The international transfer of securities may represent more permanent forces than were indicated above and thus may serve to offset long-time merchandise balances. But a transfer of securities represents an exchange of a present value for a promise to pay in the future or for a proprietary interest in a business which will yield values in the future. Thus a relatively permanent transfer of securities with which we are now concerned is an investment transaction. If, now, capital funds are relatively more plentiful, in proportion to the demand for them, in one country than in another and, therefore, interest rates on long-time investments are higher in the second country than in the first, capital will normally flow toward the country of high returns. Such a transfer of funds constitutes a debit item to the investing country and a credit item to the borrowing country. It is a debit item to the lending country, because it calls for a payment to be made by that country. In its immediate effect upon the balance of trade it is comparable to an import. This may be more clear if one visualizes the transaction as a purchase and import of securities which, of course, are paid for exactly as are merchandise imports. The lending, therefore, if it represents a net addition to the debit items, must be accompanied by a cor-

responding increase in the credit items (very probably an increase in merchandise exports). It may, on the other hand, not represent a net increase in debit items at all but merely offset a decline in some other item of this class, *e. g.*, imports, in which case the total amount of the credit side of the balance may remain unchanged. Still another view of foreign investments is possible, according to which the investing country authorizes the borrowing country to draw upon it for goods or services without the necessity of providing present goods or services in payment. The lending country's exports of present goods and services, at the time of the loan, exceed its imports of such things by the amount of the loan, this result being brought about either by the increase of the exports or by the decrease of the imports.

But investments, unlike the other items, continue to affect the balance long after the original transactions. After a loan is made interest must be paid, and this payment constitutes a credit to the investing country and a debit to the borrowing country. Of a similar nature is the repayment of the principal. It should be evident that this counter-effect upon the balance of trade comes into existence only if the payment of interest and repayment of principal is actually consummated. The mere fact that a merchandise export balance accompanied the making of international loans, would not justify the anticipation of an ultimate import balance if the debts were, in fact, never to be repaid. Such repudiated loans would have the same effect upon the balance of trade as would a war indemnity. The indemnity, like the loan, constitutes, at the time of payment, a debit item which may well lead to an increase of exports, but in neither case would there necessarily follow an import balance, such as would result from loans upon which interest and principal were repaid in the normal manner.

Another important group of items are services rendered in the conduct of international trade and the payments for those services. Certain services are international in their nature, *i. e.*, because of the nature of the service or the organization by which it is conducted, it can easily be performed by people of one

country for those of another. Prominent among these international services are shipping and insurance, especially marine insurance. The sale of shipping services stands in the same position in the trade balance as the export of physical goods: that is to say, it is a credit item. England in the past has been a leader in supplying these services, and they have gone far to offset the merchandise import balance of that country. Between 1911 and 1913 the annual credits on this account are estimated at $500,000,000.[1] Before the war the United States, on the other hand, was a purchaser of shipping services, and our annual freight bill constituted an important debit item, partially explaining our "favorable" merchandise balance.

A similar relationship existed between England and the remainder of the world in the supplying and purchasing of insurance and the services of bankers and other financial middlemen. Furthermore, at London and Liverpool are found the central markets for many commodities, which are not produced in England, but are merely assembled there as a preliminary step to their dispersion. The commissions and profits of traders engaged in this work enter into the balance as a credit to England and as a debit to the United States and other countries for whom the services are performed.

An item of especial significance to the United States is tourist expenditures abroad. American tourists in Europe consume goods and services supplied by Europeans. These must be paid for from this side as truly as though the goods were imported into the United States and consumed here. They, therefore, constitute a debit item in our balance and a credit item in the balances of the European countries. Of course, foreigners, sojourning in this country and drawing their incomes from abroad, tend to offset this item but, in fact, foreign travel is so much more common among Americans than among foreigners that the net result is decidedly a debit to us.

Again, in the case of the United States, the remittances made by recent immigrants to their European kinsfolk is also a con-

[1] Boggs, *The International Trade Balance*, p. 113.

siderable item on the debit side of our account. Europeans are called upon to supply goods and services to the recipients of these benefactions and the payment is made from this country. Therefore, it is as much a debit to us as though the recent immigrants imported the goods and consumed them themselves.

The items mentioned above are the principal ones which enter into the balance of trade of the United States and the other commerical countries to-day. It will be apparent, however, that any transaction representing a payment by people of one country to those of another should be included. The purchase of bunker coal or ships' supplies in a foreign port, the expenses of diplomatic representatives, the expenses of an army on foreign soil, contributions to foreign relief funds, and an almost endless list of other transactions, all enter, to a greater or less degree, into the international balance and so affect the volume of exports and imports or other items in the balance.

Superficially each of these transactions appears independent of the others. But a causal relationship or connecting link, whereby one item has its effect on all the others, is supplied by the rate of exchange and the adjustment of relative prices in the trading countries, as explained above in connection with the discussion of exports and imports and the rate of exchange. These factors provide the mechanism for the adjustment of one side of the account to the other and supply the checks to an overexpansion of either side relative to the other.

The Balance of Trade of the United States

The history of the balance of trade of the United States serves to illustrate the operation of these principles and to indicate how the various invisible items in international relations come in to supplement the merchandise exports and imports and thus to bring about in every period a balance between the credit and debit side of the account.

In the beginning of our existence as an independent country our commercial relations with foreign countries were characterized by two factors, which determined the nature of our balance of

trade: (1) a relatively extensive demand for the manufactured products of Europe, explainable by the paucity of manufacturing industries in this country, and (2) a remarkable development of the American merchant marine. As a result of the first factor our merchandise trade showed an excess of imports over exports, which was balanced on the debit side by earnings of American ships, both in the carrying of our own exports and in the service of other trading countries. A contemporary writer [1] described the effect of shipping upon trade by assuming an American vessel to sail from an American port with flour valued at $47,500. This cargo would sell in Spain for as much as $75,000, the advance in price representing shipping earnings, commissions, and profits. This sum having been spent for goods in the foreign country, the ship would return, showing imports in the transaction much in excess of the exports. We had sold, not only the material goods, but also the services of transporting and handling the goods. As this case was typical of our export trade in those early days the annual imports very naturally exceeded the exports.

From 1820 to 1837 an inflow of foreign capital, loaned to our states, municipalities, and public utility enterprises, supplemented our ship earnings in fostering an import balance. But after the panic of 1837, foreign investors lost confidence in American securities, and for a few years interest due on past investments exceeded new borrowing. This situation, together with the fact that improved means of transport from the interior of the country stimulated our export trade, led to a slight excess of exports over imports from 1847 to 1849.

This excess of exports, however, was an interruption of the normal course of events, and after 1849 an import balance appeared again. This was effected by a rapid increase in both exports and imports but by a more rapid growth of the latter than the former. It has been true throughout our history that the changes from one type of merchandise balance to the other have resulted from a more rapid growth of one of these, not from an

[1] Timothy Pitkin (1817), quoted in Bullock, Williams and Tucker, *The Balance of Trade of the United States*, The Review of Economic Statistics, July, 1919.

absolute decline of the other. The new factor after 1849 which made possible this import balance was a new and large export of gold resulting from the gold discoveries in California. Shipping earnings also continued, and there was some new investment of capital, but the export of gold was the most potent of the non-merchandise factors. In the whole period, 1850–1859, inclusive, the excess of merchandise imports was $364,000,000, while exports of gold and silver amounted to $362,000,000.

The trade balance of this period supplies an illustration of the effect of the gold supply of a country upon trade. The most natural disposition of the new gold was to convert it into money for domestic use. But the production was so large that if the money so converted had been retained within the country, the money supply would have increased in the one decade from about twelve dollars per capita to over twenty-five dollars.[1] Such a radical change in the money supply would have caused an increase in prices so great as to have prevented the export of many American products and to have fostered imports to a marked degree. It worked out as would have been expected. Part of this gold flowing to the mint and from there into the monetary circulation, increased prices sufficiently to cause an excess of merchandise imports. A large part of the new gold, therefore, flowed abroad to offset the "unfavorable" merchandise balance.

In these years, then, we were importing largely in excess of our exports and paying the difference in gold. Careful note should be made, however, of the very exceptional circumstances prevailing, for ordinarily we are safe in assuming that a long continued balance cannot be settled in this way. It is possible (1) when the gold-exporting country is producing gold equal to or in excess of its gold exports, or (2) to a lesser degree, when the gold-exporting country is shifting from a gold currency to paper money. The character of the period 1850–1859 was largely influenced by gold production, and the gold exports of this period, therefore, serve as the exceptional case which tends to prove the general

[1] Bullock, Williams and Tucker, *op. cit.*, p. 222.

rule, rather than as an example of normal trade relations. The influence of a paper currency is illustrated by the next period.

The "unfavorable" balance continued through and after the Civil War. But ship earnings, which had been one of the important credit items, now changed to a debit item. The Civil War marked a sharp decline of our merchant marine, though the war itself was only the immediate cause of that decline. Gold shipments, on the other hand, increased. During the war this increased export of gold represented a reduction in our gold monetary supply, paper money taking its place, and after the war the gold flowed again from the mines. Another important factor after the war was a resumption of foreign investing, especially in our railroads and other projects involved in the development of the West, and this also contributed to an "unfavorable" balance.

The most significant shift in the history of our merchandise balance of trade came in 1874, when an excess of exports appeared. This excess has continued to the present time. The radical and sudden change from an import balance of $119,000,000 in 1873 to an export balance of $19,000,000 in 1874 was occasioned by a world panic which interrupted European lending and checked American railroad building. The former result cut off one of our principal credit items, and the latter contributed to a fall in prices and money incomes in the United States, which forced a reduction of imports while exports increased slightly.

In the succeeding years, agricultural exports increased greatly, partly due to fortuitous circumstances—a series of poor crops in Europe and bumper crops here. These circumstances, however, merely made the change more marked than it would otherwise have been. Our debt to Europe on capital account had become so great that interest payments constituted an ever growing debit item; our merchant marine had almost disappeared and, therefore, the freight receivable had given way to freight payable; gold production was not increasing, but rather showing a tendency to decline, while gold was again displacing paper in our circulating medium and, therefore, imports of gold in several

years exceeded exports. This reinstating of our currency upon a gold basis, combined with a slight decline in our gold production and with the other factors mentioned, led to a continued decline in prices. All these contributed to the change, but the interest item was the most important. In a general way these factors continued for two decades. The results can be set forth as follows, if we remember that this tabulation shows only the results for the whole period, and not the changes within the period, and further that for some of the items we are forced to rely upon careful estimates.

TABLE 3. THE ANNUAL AVERAGE BALANCE OF INTERNATIONAL INDEBTEDNESS OF THE UNITED STATES, 1874–1895 [1]
(UNITS OF $1,000,000)

	Credit	*Debit*
Excess of exports of merchandise and silver	113.3	
Excess of exports of gold	5.0	
New capital borrowings	45.4	
Interest charges		85.0
Freight charges		25.4
Tourist expenditures		35.0
Immigrant remittances and miscellaneous items		20.0
Totals	163.8	165.4

[1] Bullock, Williams and Tucker, *op. cit.*, p. 227.

From 1895 to the outbreak of the European War our merchandise balance of trade became even more distinctly favorable. This fact was explained on the merchandise side in the early part of the period by increased exports of agricultural products,—from $558,000,000 in 1895 to $951,000,000 in 1901. In the next decade there was no general increase of exports of this class, but their place was more than filled by the great increase in exports of manufactured goods, beginning about 1900 and resulting from the great industrial development of the period. On the side of the invisible items, interest payments, which played such an important rôle in the preceding period, were even larger, for borrowing had continued. The annual debit item on this account was about $160,000,000 as compared to $85,000,000 in the earlier

period. The most striking development, however, was the great increase in the expenditures of American tourists, which in this period constituted an annual debit item of $170,000,000, and immigrant remittances, which amounted to $150,000,000. The salient characteristics of the period 1895–1914 were thus very large "invisible" debit items, chief among which were: tourist expenditures, immigrant remittances, interest payable, freight charges payable, and insurance premiums, commissions and similar items for services purchased from foreigners. These were paid for by a considerable excess of merchandise exports over imports and, to a much smaller extent, by new capital borrowings from abroad.

The outstanding feature of our trade balance during the war was the great increase in merchandise exports and in the amount by which they exceeded the imports. The increase was caused in part by a considerable increase in the volume of physical goods exported, but even more by the enhanced prices at which the goods were sold. For our present purpose the total values of the exports and imports, and not merely their physical volume, are significant. Gold shipments and capital items were the most important offsetting factors. Throughout our period of neutrality the more important modes of settlement of the excessive export balance were shipments of gold to us and the resale to us of American securities held abroad. In the brief period from 1914 to 1917 we very largely paid the debt owing to European investors. This fact appears the more remarkable when we contrast the time required for repayment with the long period through which the debt had been accumulating. Beginning with 1917 huge loans were advanced to our allies. In large part these loans were made directly to the buyers of American goods and were often in the form of credits established here for that purpose. They, of course, acted as a direct offset to our exports and made the exports possible. If, however, we recall the principles of the balance of trade, it will be apparent that the same result would probably have followed had the loans and the exports not been connected in this direct manner.

The following table brings together the result for the whole war period.

TABLE 4. BALANCE OF INTERNATIONAL INDEBTEDNESS OF THE UNITED STATES, JULY 1, 1914, TO DECEMBER 31, 1918[1]
(UNITS OF $1,000,000)

	Credit	*Debit*
Excess of exports of merchandise and silver	11,808	
Net interest receivable	650	
Net imports of gold		1,029
American securities returned		2,000
Loans to foreign countries		8,840
Net freight charges and ship chartering		426
Immigrant remittances		600
Totals	12,458	12,895

[1] Bullock, Williams and Tucker, *op. cit.*, p. 252. Note that this table presents results for the whole period, while the preceding table dealt with annual averages.

There was left a net debit of $437,000,000, probably accounted for by the credit extended by this country but not utilized by the end of the period.

The interest item shifted from the debit side to the credit side of our balance. By the end of the war period annual interest payments due to us amounted to about $525,000,000 contrasted with interest due from us of $160,000,000 in the pre-war period. This item of interest receivable has grown considerably since the armistice. But uncertainty shrouds the whole question for, as remarked above, this item is of significance in our trade balance only when and if it is actually paid. Freight payable is not likely, for the present, to constitute an important debit item as it did before the war. On the other hand, tourist expenditures are likely to be larger. As far as these items are concerned, therefore, we are probably justified in looking for a disappearance of our large excess of exports which has prevailed since 1873. On the other hand, the future trend of American foreign investment will be very influential. A considerable flow of American capital abroad would make for a continuation of our "favorable" balance for the immediate future, although it would make an ulti-

mate reversal of the trade balance the more inevitable. If, however, our investments do not materially increase (which seems more probable) we should look for an approximately even balance. At any rate, the old relation of capital and interest items has disappeared, and our trade balance, whatever it may be, will be the result of quite different factors than we were accustomed to in 1914.

The United Kingdom and Germany

The balance of trade of Great Britain before the war serves to illustrate the relation between the merchandise and invisible items under very different conditions than those which surrounded the United States. Great Britain's balance of trade in many respects was almost a perfect antithesis of our own. On the score of merchandise transactions her trade showed a considerable excess of imports over exports and this excess had been characteristic of her trade since about 1840. The invisible items, which were for us in 1913 principally on the debit side of the balance, were among Britain's important credits. Where we had a large freight bill payable every year, Great Britain had a net receipt on this account of some £100,000,000 annually. Whereas we were paying interest, Britain was receiving interest of about £185,000,000, which, however, in the year 1913 was offset by an equal investment abroad.

The following is an estimate of the manner in which these items fitted into the balance in 1913 and 1922.

TABLE 5. TRADE BALANCE OF THE UNITED KINGDOM 1913 AND 1922 [1] (UNITS OF £1,000,000)

	1913	*1922*
Credits		
Exports, domestic and foreign	599	820
Excess of gold exports over imports		10
Interest receivable	185	150
Ship earnings	100	90
Commissions, insurance premiums, etc., receivable	55	50
Foreign capital investments in United Kingdom		50
Total credits	939	1170
Debits		
Imports	745	960
Excess of gold imports over exports	11	
Interest payable	20	65
Investments made abroad	185	150
Total debits	961	1175

[1] Arranged from estimates of Mr. Edgar Crammond, *Bankers' Magazine* (London), January, 1923.

The position which Great Britain held in 1913 and the nature of its trade balance were the results of a very long period of foreign investment, which had culminated in large annual interest receipts. The changes in Great Britain's trade balance since 1913 have not been as marked as might well be expected. According to a recent estimate the total British investment in foreign lands declined from £4,000,000,000 to £3,000,000,000 and the interest receivable from £185,000,000 to £150,000,000. Interest payable on British war time borrowing from foreign countries and the colonies is now almost £65,000,000. Ship earnings dropped from £100,000,000 to £90,000,000, but this drop is principally explained by the level of freight rates, for the country had slightly more tonnage in 1922 than in 1914. The excess of imports amounted to almost the same sum in the two years and, broadly speaking, the balance was met in much the same manner.

The pre-war trade balance of Germany was of the same type as was Great Britain's, *i. e.*, the country imported merchandise in excess of its exports, meeting this "unfavorable" balance by interest receipts and shipping, which items left a surplus for new investments abroad. The difference was one of degree. Ger-

many's invisible items were not so important as Britain's, partly because its period of large foreign investments had been shorter and partly because its merchant marine was smaller. As an industrial and capitalistic country it was in a less mature stage than was England. The chief items of Germany's pre-war balance are indicated in the following statement.

TABLE 6. GERMAN TRADE BALANCE IN 1912 [1]
(UNITS OF £1,000,000)

	Credit	*Debit*
Merchandise exports	484	
Interest receivable	50	
Ship earnings	30	
Commissions, premiums, etc	10	
Merchandise imports		579
Excess of gold imports over exports		9
Capital invested abroad		13
Totals	574	601

[1] Crammond, *loc. cit.* Data are given in pounds sterling to facilitate comparison with the preceding table.

THE "FAVORABLE" BALANCE

Now that we have become familiar with the many items which enter into a country's balance of payments with other countries, we may note a marked change which has come about in the manner in which statesmen and economists view this balance. The prevalent theories and the practical measures growing out of those theories, in the fifteenth, sixteenth, and seventeenth centuries, are together known as the mercantile system. This system of thought and policy was characterized by an extreme nationalism which manifested itself in many ways. In the field of foreign trade the mercantilists placed greatest store by the relation between exports and imports. This attitude arose in part, at least, from their concept of gold as the most important form of wealth for a country. If a country produced no gold, it appeared that the trade of that country should be directed to obtaining gold in exchange for its own products. But it was possible to obtain gold only by exporting more of produce than was imported and re-

ceiving the balance in gold. This "favorable" balance thus became the end and aim of foreign trade.

This desire for a "favorable" balance led to a two sided regulation of trade. On the one hand, exports of merchandise were fostered by bounties, subsidies, commercial treaties, and restrictions upon the trade of colonies. On the other hand, imports were restricted both by import duties of general application and by special restrictions on imports from those countries with which an "unfavorable" balance existed. Beside attempting to make conditions favorable to an importation of gold and unfavorable to its exporation by these regulations upon trade, specific prohibitions upon the export of the precious metals were enacted.

Foreign trade and domestic trade were viewed as essentially different. It was only by means of the former, and then only when a "favorable" balance existed, that a nation, as a whole, could become rich. Domestic trade merely passed goods and services from one citizen to another and could, therefore, not bring a net increase in the nation's wealth.

We now realize that gold is only one of many forms of wealth and not necessarily the most important. The annual income of a country consists of the product of the industry of that country and the wealth of the country consists of all those goods and services which cater to the satisfaction of human wants, either directly or, as with capital goods, indirectly. The trade within a country enhances wealth and prosperity by making goods available at the places and at the times desired. The most important advantages of trade, as described in previous chapters, apply equally to domestic and foreign trade, and the two accomplish practically the same results. They enable people to exchange the relatively superfluous things, or rather units of things, for relatively more important things; they facilitate the extension of the principle of division of labor and thus benefit both buyers and sellers—producers and consumers. Further, it appears from the trade balances of the three countries reviewed above, that a "favorable" balance of trade does not necessarily lead to an inflow of gold, nor that an "unfavorable" balance leads to an outflow of

gold. Nothing can be predicted on this score for, first, there are so many items entering into the complete balance that some of them may more than offset a merchandise balance, either of one kind or the other, and, second, a continued inflow of gold into a country would normally, as we have seen, set in motion forces which would soon reverse the flow. Similar results follow a continued outflow of gold.

It is true that there are circumstances which may justify a country in attempting to protect its gold supply. Gold in our modern commercial system plays an important rôle as reserves for bank credit and the circulating paper money. While it is true that the normal forces of trade will in the long run tend to prevent an undue depletion of reserves, the bankers or government officials may not be willing to go through the readjustments necessary for the working out of these forces. They may resort, therefore, to a manipulation of the discount rate or other devices to discourage the outflow or encourage the inflow of gold. They are special circumstances, however, which justify such moves, and the wisdom of such a policy is not so universal as the mercantilists imagined. Indeed, bankers or statesmen who have the interests of the whole community at heart may at times fear the result of too great an inflow of gold as much as they fear the opposite tendency at other times. That is to say, there are no general grounds on which we can view an inflow of gold, in itself, as a desirable end. It depends upon the supply of gold in the country, the volume of business to be conducted, the condition of the monetary and credit system of the country, and other circumstances. Under normal trade the most desirable allocation of the world's gold supply among the nations is likely to be effected by an absence of regulations designed to bring about a "favorable" balance of trade.

CHAPTER VII

RECENT TENDENCIES IN THE FOREIGN TRADE OF THE UNITED STATES

Many of the outstanding characteristics of American foreign trade are the results of comparatively recent developments and some of these developments are not yet completed. An analysis of these tendencies should assist us to a better appreciation of our present position and to a more rational judgment of future tendencies. In referring to recent tendencies we do not have primarily in mind those changes wrought by the recent war. The war has, of course, left its effects upon our foreign trade, and some of these effects may be permanent, but there were pronounced tendencies in our trade before the war which are still to be reckoned with. The purpose of this chapter is to describe these pre-war tendencies as well as to note the developments of the past decade.

The Volume of American Foreign Trade

The growth of the volume of foreign trade of the United States has been astounding. A mere outline of this growth will serve as a background for the consideration of some present tendencies. Table 7 sets forth the value of exports and imports and the total foreign trade of the country in decennial years from 1800 to the present.[1]

[1] The United States Department of Commerce is the only original source of data on exports and imports of the United States. These data are published in the annual volumes of *Commerce and Navigation of the United States* and some are given also in summary form in the *Statistical Abstract of the United States* and, recently, in the *Monthly Survey of Current Business*. All are published by the Department of Commerce. The statistics in this chapter are adapted from these sources except as otherwise specifically indicated.

TABLE 7. THE FOREIGN COMMERCE OF THE UNITED STATES
(In Millions)

Year [1]	Exports	Imports	Total
1800	$ 71	$ 91	$ 162
1810	67	85	152
1820	70	74	144
1830	72	63	135
1840	124	98	222
1850	144	173	317
1860	334	354	688
1870	393	436	829
1880	836	668	1,504
1890	858	789	1,647
1900	1,394	850	2,244
1910	1,745	1,557	3,302
1920	8,109	5,238	13,347
1921	4,485	2,509	6,994

[1] Fiscal years except 1921 which is the calendar year.

The foreign trade of the period 1789 to 1815 was large, as compared with the domestic trade, as compared with the population, and also as compared with the trade of many of the succeeding years. It was, however, on a precarious footing, as it rested upon the wars and commercial rivalries of the European countries. With the cessation of these wars we turned more and more to domestic trade and industry and from 1820 to 1850 there was but a slow growth of American foreign commerce. Even this growth was explained by the extensive development of one industry—cotton growing. In 1860 only about one-third of the total exports of the country came from the North. The movement of the population westward into the Mississippi Valley and the development of that region absorbed the attention of the people and did not at once lead to an export of the products of that region. After 1870, however, with the development of cheap transportation in the Middle West, the agricultural products of that region came to assume a much more important position, and our total trade advanced rapidly. Exports more than doubled between 1870 and 1880. Another period of rapid growth began about 1900, stimulated by the development of American manufactures,

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and this growth continued to the opening of the war, when still newer forces acted greatly to increase our trade.

This growth of our foreign commerce, remarkable as it has truly been, has only been consistent with other phases of the country's development. This fact is in part indicated by a consideration of our foreign commerce in proportion to our population. Chart 1 presents our per capita trade in the decennial years.

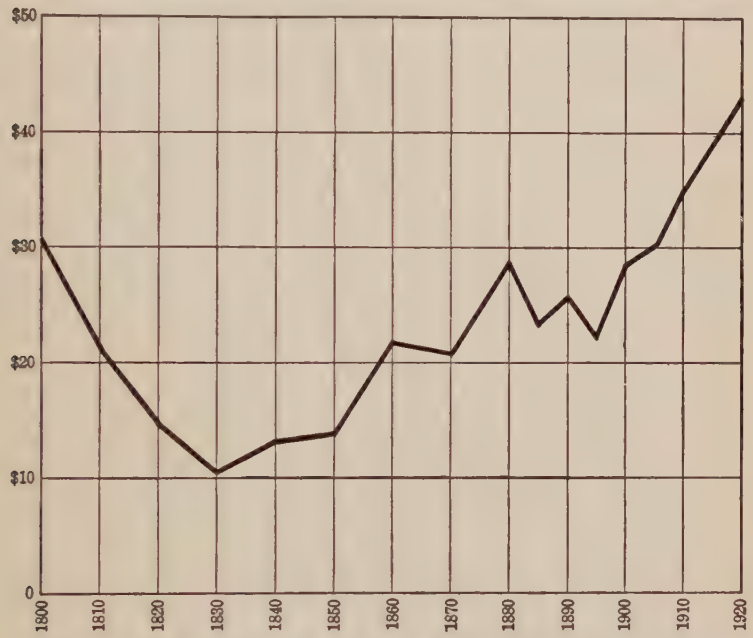


Chart 1. The Foreign Trade per capita of the United States, 1800–1920

It will be noted that throughout our early history our foreign commerce did not keep pace with the growth of population, — that, in fact, the per capita trade was larger in 1800 than in any subsequent year up to 1905. The share of each person in the foreign commerce of the country in 1913 exceeded the corresponding figure for 1800 by only $12.04. When the above chart is viewed in the light of the rising price level of recent years, which naturally enhanced the values of the products entering into foreign commerce, and in the light of the increased tendency to sat-

isfy our wants by buying and selling rather than by direct production of goods for our individual needs, the increase in per capita trade seems surprisingly small. It apparently indicates that throughout most of our history our country has been, to a very large degree, economically self-contained. It further indicates that our dependence upon foreign markets and foreign sources of supply is not, when viewed in this way, so much greater to-day than in the past, as is sometimes assumed. The increasingly active interest in our foreign commerce in recent years must be explained upon grounds other than the mere fact of its increased volume.

The European War brought radical changes in our foreign trade. The trade of these years should be separately noted, partly because the changes were so much more violent than those of preceding years, and partly because there is a difference of opinion as to whether these changes should be viewed as merely an extraordinary acceleration of normal tendencies or as utterly divorced from the pre-war movement.

The gradual upward movement of the value of our foreign trade was replaced by sudden and phenomenal increases. Very soon after the outbreak of the war the demands of the belligerent countries made themselves felt, and in 1915 exports increased, although imports in that year declined. By 1916 American industry had responded to the European demand, and not only increased its sale of goods to Europe, but also its imports of goods from other parts of the world. The year 1917 saw a still greater increase in both exports and imports. The official figures for 1918 show an increase of imports over the preceding year, but a slight decline in exports. In part, this decline is explained by the facts that exports on government account are not included in the figures given and that these exports were especially large in 1918; but, on the other hand, there may have been an actual decline in exports, due to the diversion of a large number of workers to the military forces.[1] The year 1919, instead of showing a slump

[1] The latter is the view of W. A. Berridge, *The Review of Economic Statistics*, October, 1919; the former is asserted by Simon Litman, *American Economic Review*, June, 1920.

from our war trade, as some had anticipated, reached a new high mark, which was, in turn, surpassed by 1920. The end to this phenomenal growth of trade came in 1921, and since that time there has been a tendency for our trade to return to its old basis—in volume, in the relation of exports to imports, in direction, and in the types of goods involved.

The great increase in our foreign trade during the war period is familiar to all. Remarkable as it was, a statement of the tendencies in our export trade in terms of dollars is, for some purposes, misleading. The increase in the value of our exports was occasioned by the increased value per unit of the goods as well as by the increased volume; in fact, during most of the war period, the price changes were more potent in explaining the huge figures of our export trade than was the actual volume of goods. The physical quantities of goods exported can only be estimated. According to one study, the quantities and values of the United States' exports in the war years are expressed in index numbers thus:

INDEX NUMBERS OF EXPORTS DURING THE WAR PERIOD [1]

(Annual Average 1911–1914 = 100)

	1911–14	1915	1916	1917	1918	1919
Values	100	123	191	279	261	317
Quantities	100	122	157	171	125	140

[1] W. A. Berridge, *The Review of Economic Statistics*, October, 1919, p. 312.

If we consider the year 1917, for example, it appears that the value of our exports had increased over the pre-war level by 179 per cent, but most of this was due to the enhanced prices at which the exported goods were sold, for the physical volume of goods exported had increased by only 71 per cent. In 1918 the volume of goods exported was only 25 per cent greater than in the pre-war years, although the total value of exports had increased by 161 per cent. It was a remarkable feat for a country to increase its exports as this country did between 1914 and 1917, but this accomplishment is to be measured by the increase in volume of exports of 71 per cent, not by the increase in value of exports of 179

per cent, for the largest part of this increase was due to price factors over which American producers had little control. A consideration, therefore, of the foreign trade of the war period, in terms of values only, would give, for some purposes, a very exaggerated picture of the changes. On the other hand, these values are most significant in their effect upon our balance of trade and the balance of international indebtedness.

Likewise, the sharp decline in the value of our exports since 1920 is to be explained very largely by changes in the prices of the goods exported. For example, the value of United States' exports declined from 8.2 billion dollars in 1920 to 4.5 billion dollars in 1921, but the quantities of goods exported appear to have increased slightly. The values and quantities of imports and exports since 1919 are compared in Table 8.

TABLE 8. INDEX NUMBERS OF THE QUANTITIES AND VALUES OF RECENT UNITED STATES TRADE [1]

(EXPORTS AND IMPORTS OF 1913 = 100)

	EXPORTS		IMPORTS	
	Values	*Quantities*	*Values*	*Quantities*
1913	100	100	100	100
1919	317	115	218	168
1920	330	107	295	169
1921	179	109	140	136
1922	154	101	174	189

[1] Index numbers of values are from *Survey of Current Business*, August, 1923, pp. 186 and 187. Index numbers of quantities are from *Federal Reserve Bulletin*, August, 1923, p. 933.

THE RELATIVE VOLUME OF FOREIGN AND DOMESTIC TRADE

In a preceding paragraph we have noted the per capita foreign trade of the United States. This throws some light upon, although it does not directly answer, a question often discussed: what is the relative importance of our foreign and domestic trade? Obviously, the question put in just this way cannot be quantitatively answered, for importance is not necessarily measured by volume. Even an attempt to discover the relative volume of foreign and domestic trade is beset with many difficulties, for there are, in popular use, many differing concepts of trade. While we

all have a general notion of the meaning of the term, there is little agreement, even among economists, upon a definition of trade for purposes of definite measurement. One study indicates that the foreign trade of the United States, for the year 1915, was less than 1 per cent of the total trade. Another study concludes that the foreign trade of 1915 was 16.4 per cent as large as the domestic trade.[1] This figure no doubt gives a more nearly correct view of the relative importance of foreign and domestic trade, although the present writer feels that the method employed is subject to criticism. Rather than seek one figure to express the relationship we shall be content to answer two questions.

The people of the United States have, in any year, a total income which, for some years at least, has been measured with approximate accuracy. This income is spent for goods and services. Now, if we compare the total income, thinking of it for the moment as the amount spent rather than as the amount received, with the value of imports, we will have an answer to the question: How much of the total income of the people of the United States is spent upon foreign goods? The value of imports should be viewed as a part of the larger figure. Such a comparison is made in Table 9.

[1] The lower estimate appeared in the *New York Times Annalist*, January 17, 1916; the higher in B. M. Anderson, Jr., *The Value of Money*, pp. 267–278. In the opinion of the present writer the former estimate erred in adopting a figure for domestic trade which, for the purpose in hand, although not for some other purposes, was much too large. Dr. Anderson, on the other hand, makes up his figure for foreign trade by taking the value of exports and imports at retail prices. The propriety of this procedure is questioned, because, although it is true that imports and exports are ultimately sold at retail prices, they do not enter into foreign trade at these prices. The price which the consumer pays for imported goods is the sum of two items: the price to the wholesaler, most of which goes to foreigners, and the domestic trader's margin, which is obviously not paid to foreigners but to domestic traders and hence should appear as a part of the value of domestic trade, not of foreign trade.

TABLE 9. NATIONAL INCOME AND IMPORTS OF THE UNITED STATES [1]

(In Millions)

Year	National Income	Imports	Imports as a Percentage of National Income
1890	$ 9,300	$ 823	8.8
1891	10,400	828	8.0
1892	10,000	840	8.4
1893	10,100	776	7.7
1894	8,300	676	8.1
1895	8,400	801	9.6
1896	7,900	681	8.6
1897	8,000	742	9.0
1898	9,100	634	7.0
1899	10,900	798	7.3
1900	12,900	829	6.4
1901	14,600	880	6.0
1902	15,600	969	6.2
1903	17,700	995	5.6
1904	18,000	1,035	5.7
1905	19,600	1,179	6.0
1906	21,500	1,320	6.1
1907	26,600	1,423	5.3
1908	23,000	1,116	4.8
1909	28,800	1,475	5.1
1910	31,400	1,562	5.0
1911	31,200	1,532	5.0
1912	33,000	1,818	5.5
1913	34,400	1,792	5.2
1914	33,200	1,789	5.4
1915	36,000	1,778	4.9
1916	45,400	2,391	5.4
1917	53,900	2,952	5.5
1918	61,000	3,031	4.9
1919	66,000	3,904	5.9

[1] Data for national income for 1909 to 1919 are from *Income in the United States*, National Bureau of Economic Research; from 1890 to 1908 estimates of national income are those of B. M. Anderson, Jr., *The Value of Money*, p. 277. Both imports and national income are for calendar years.

This comparison of national income and imports gives us a measure of the part which expenditures for foreign goods played in our total expenditures. Thus, in 1913 the people of the United States had a total income of about 34½ billion dollars, of which

about 1.8 billion dollars, or 5 per cent, was paid to foreigners for goods purchased from them. This figure is smaller than we should be led to expect from many discussions of foreign trade. It indicates that, compared with our dependence upon our own sources of supplies, our dependence upon foreign sources is relatively slight.

The amount paid for foreign goods, however, does not accurately measure the importance of the imports. Some of these imports were products which could not be produced at home, at least not at costs which would make it possible for most people to consume them. Coffee and tea are examples. If our import trade were to be closed, the inconvenience suffered would be far greater than would be indicated by the present values of those imports. But, on the other hand, there are many domestic products which could be obtained from abroad only at greatly increased cost. This consideration offsets the previous one and we will probably be not far from a just view if we consider the above figures to represent the relative importance of foreign goods as a part of the total goods and services utilized by Americans.

We can now shift our point of view and consider the United States as a producer of goods and services. These goods and services were sold for an amount represented by the national income. Part of these goods and services were sold to Americans and part to foreigners. That part of the national income obtained by selling goods to foreigners is represented by the value of our merchandise exports. We may set for ourselves the question: What proportion of our income, measured by pecuniary standards, was obtained by the sale of goods to foreigners? An answer to this question will be supplied by dividing the value of our exports by the value of the national income. The results of this computation for the years 1890 to 1919 are set forth in Table 10.

TABLE 10. NATIONAL INCOME AND EXPORTS OF THE UNITED STATES [1]

(In Millions)

Year	National Income	Exports	Exports as a Percentage of National Income
1890	$ 9,300	$ 857	9.2
1891	10,400	970	9.5
1892	10,000	938	9.4
1893	10,100	876	8.7
1894	8,300	825	10.0
1895	8,400	824	9.8
1896	7,900	1,005	12.7
1897	8,000	1,099	13.7
1898	9,100	1,225	13.6
1899	10,900	1,275	11.2
1900	12,900	1,477	11.4
1901	14,600	1,465	10.0
1902	15,600	1,360	8.7
1903	17,700	1,484	8.4
1904	18,000	1,451	8.1
1905	19,600	1,626	8.2
1906	21,500	1,798	8.3
1907	26,600	1,923	7.2
1908	23,000	1,752	7.6
1909	28,800	1,728	6.0
1910	31,400	1,866	6.0
1911	31,200	2,092	6.7
1912	33,000	2,399	7.2
1913	34,400	2,484	7.2
1914	33,200	2,113	6.3
1915	36,000	3,554	9.9
1916	45,400	5,482	12.0
1917	53,900	6,233	11.5
1918	61,000	6,149	10.0
1919	66,000	7,920	12.0

[1] See footnote to preceding table.

In 1913, for example, 2.4 billion dollars, or about 7 per cent of our national income, was obtained by the sale of goods to foreigners, from which we can conclude that about 7 per cent of our labor, capital, and energies was devoted to the production of goods for the foreign market.

Now, thinking of ourselves as producers, how important is our

export trade to us? The above figures would seem to indicate that, compared to our domestic trade, it is relatively slight. Furthermore, if our export trade were to disappear permanently or to diminish in volume the loss would not necessarily be as great as would be indicated by such diminution for the goods now exported would be sold at home or the energies involved in the production of the export goods would be diverted to the production of other goods for the domestic market. This would represent a loss, but not a total loss. If, however, we contemplate a more likely thing,—an increase or a decrease in our exports from year to year, we must conclude that such changes are very significant for the whole prosperity of the country. No matter how small the export trade may be relative to the domestic trade, our whole industrial equipment is adjusted to supplying both the foreign and domestic demand, and a temporary change in the former is likely to have widespread results, quite out of proportion to the actual volume of trade involved.

It will be noted that the popular notion that our foreign trade was coming to be more and more important to us, receives little support from these figures. There was an increasing proportion of exports to national income during the dark years from 1893 to 1898, but with the definite return of prosperity and of rapid industrial growth there began a decline. It will be recalled that it was at about this time that European manufacturers began to express concern about the "American invasion" of Europe, referring to the sale there of American manufactured goods. It is true that for some industries the foreign market was tending to be more and more important, but for others, notably the agricultural industries, the opposite tendency was pronounced.

The preceding figures indicate the proportion of the national income obtained by the production of goods for export and their sale to foreigners. But the national income is obtained from other sources than the production of goods. In part, it is obtained by commerce (the handling and distributing of those goods), and in part, from personal services not connected with goods in any way. The above figures, therefore, represent the sources of the na-

tional income but not the division of physical goods between the domestic and the foreign market.

We turn, therefore, to another comparison. We start with the value of the products of agriculture, mining, and manufacturing, using the values of these products as they leave the hands of the producers, not their value after distribution to the consumer. Part of these goods were sold abroad, and a figure representative of this part and comparable to the larger figure for total product is furnished by the value of exports. A comparison of these two figures will indicate the relative importance of the domestic and the foreign market to the producers of physical goods. Such a comparison is set forth in Table 11.

TABLE 11. PROPORTION OF VALUE PRODUCT OF MAJOR INDUSTRIES EXPORTED

	Exports (*In millions*)	Income from Agriculture, Mining, and Manufacture [1] (*In millions*)	Exports as a Proportion of the Total Value of Product $\left(\frac{\text{col. 1}}{\text{col. 2}}\right)$
	1	2	
1909	$1,728	$14,315	12%
1910	1,866	15,969	12%
1911	2,093	15,195	14%
1912	2,399	15,272	15%
1913	2,484	17,576	14%
1914	2,114	16,335	13%
1915	3,555	17,716	20%
1916	5,483	23,895	23%
1917	6,234	29,131	21%
1918	6,149	33,697	18%

[1] National Bureau of Economic Research, *Income of the United States*, Vol. I, p. 18.

It appears that in the pre-war years the exports from the United States took about 12 to 15 per cent of the total value of the physical products of the country and there was no marked tendency for the proportion to increase. Beginning with 1915, however, there was a marked increase, not only in the exports themselves, but in the proportion of our total product exported.

There are presented, in Table 12, figures indicating, for some of our important industries, the proportion of the products sold abroad.

TABLE 12. PROPORTION OF THE PRODUCT OF CERTAIN INDUSTRIES EXPORTED [1]

	Per Cent of Total Product Exported	
	1914	*1919*
Machinery		
Shoe machinery	19	17
Typesetting machinery	20	26
Internal combustion engines	9	9
Electrical machinery and supplies	6	9
Adding and calculating machines	8	7
Pumps and pumping machines	11	14
Typewriters	37	40
Sewing machines	38	28
Mining machinery	30	16
Cash registers	20	14
Agricultural implements	13	13
Other Manufactured Goods		
Automobiles	6	5
Cotton goods	7	12
Boots and shoes	3	6
Steel rails	10	25
Railway cars	4	11
Wire and manufactures of	9	18
Rubber goods	4	5
Farm Products		
Dressed meats	3	13
Lard	28	37
Wheat	19	31
Tobacco	44	46
Cotton	52	56
Other Raw Materials		
Copper	69	36
Coal—bituminous	4	4
Coal—anthracite	5	5
Oil refinery products	34	20

[1] In some instances the figures are based upon physical units of the product. This has been done with the agricultural products. In most cases, however, values have been used. Data concerning exports and imports are from *Commerce and Navigation*, 1914 and 1919; those for the value of manufactured products are from *Census of Manufactures*, 1914 and 1919; and for the value of agricultural products, from the *Statistical Abstract of the United States*, 1921, which bases its computations upon data of the Department of Agriculture.

The relative volume of domestic and foreign sales, of course, varies greatly between different lines of industry. Over half the output of some industries is exported, while many other industries have no direct interest in foreign markets. This difference can be explained on several grounds. There are many products whose costs of production in this country are so nearly the same as that in other countries that, although they are not imported, neither can they be profitably exported. In other cases the physical nature of the product restricts its sale to a market comparatively close to the center of production. This is true of cement, gravel, stone, and other products of low specific value. Transportation costs are so high in proportion to their value as to make their export commercially unprofitable. Other products are so perishable that their markets are necessarily restricted, although modern refrigeration has largely overcome this obstacle. Another group of products such as houses, factories, dams, roadbeds for railroads, and highways are, in the nature of the case, domestic products.

As was suggested in Chapter III, foreign trade is of less significance to us than it is to many other countries because of the greater diversity of industries in the United States. This is further substantiated by a comparison of the income from exports with the total national income in some of the leading countries in immediate pre-war years. Such a comparison is made in Table 13.

TABLE 13. TOTAL INCOME OF PRINCIPAL COUNTRIES AND THE PART OF THAT INCOME OBTAINED BY SALE OF GOODS TO FOREIGNERS IN 1913–14 [1]

(In Millions of Dollars)

	Income	Value of Exports	Percentage of Exports to Total Income
United States	33,200	$2,329	7
United Kingdom	10,950	2,556	23
Germany	10,460	2,403	23
France	7,300	1,326	18
Italy	3,890	483	12
Austria-Hungary	5,350	562	10.5
Spain	1,120	194	17
Australia	1,260	365	29
Canada	1,460	431	29
Japan	1,580	315	20

[1] Income data from *Income of the United States*, p. 85. Export data from *Statistical Abstract of United States*, 1914, p. 688. The income estimates are probably of varying degrees of accuracy. The National Bureau of Economic Research believes the figures for the United States, United Kingdom, Germany, and Australia to have the highest degree of accuracy. Income estimates are for 1914 while exports are for the last complete year before the war.

Almost a quarter of the total income of both the United Kingdom and Germany was obtained by the sale of goods abroad. If services sold to foreigners, such as shipping services, banking and insurance services, and the use of capital, were to be included, it would appear that over one-third of the total income of the United Kingdom was, in 1913, obtained from transactions of one kind or another with foreigners. Another indication of the importance of the foreign trade to Great Britain is the fact that about one-third of the aggregate output of goods is assigned to the export trade.[2]

Of the above countries, Australia and Canada are typical of the "newer" lands, exporting their raw materials and foodstuffs and importing their manufactures. This specialization means that a large part of their income arises from foreign sources. The same result flows from a specialization of the opposite nature. The United States, standing midway between these two extremes, is

[2] According to the *Census of Production*, 1907.

more self-contained. Foreign trade is of greatest importance to countries in the early stages or the late stages of industrial development. There is a "middle period" in which the lines of production are so balanced that there is relatively little dependence upon foreigners either for supplies or for a market.

The Foreign Trade of the Principal Countries

We now turn to a comparison of the recent progress of the foreign trade of the United States with that of other countries. By 1913, three countries stood out as leaders in the international commerce of the world: Great Britain, Germany, and the United States, listed in the order of the value of their total foreign trade. These were followed by France, the Netherlands, and Belgium. Great Britain, throughout modern times, had held the premier position, and, although its rate of increase in the two pre-war decades had not been as great as that of Germany and the United States, its total trade was still 39 per cent greater than that of Germany and 57 per cent greater than our own. However, an ever larger part of this total trade consisted of imports, while in the United States the opposite trend prevailed and in Germany, although imports were in excess of exports, the latter were increasing more rapidly than were those of Great Britain. From a certain point of view—probably the most justifiable one—this growth of the trade of each country was not an unfortunate development for the others. Britain's great imports were, in part at least, the exports of the United States and Germany, while the exports of Germany and Great Britain provided many of our imports. That is to say, the prosperity of each was intimately connected with the prosperity of the others—a fact which is more appreciated to-day than it was in 1914. Nevertheless, it was possible—and this was by far the more popular view—to envisage the other countries solely as rivals in a race for commercial supremacy. Inspired by this concept there was much knitting of brows in England and elation in the United States and Germany over the trend of international trade.

The following diagram portrays the development of the export

trade of Great Britain, Germany, and the United States from 1872 to the beginning of the war.

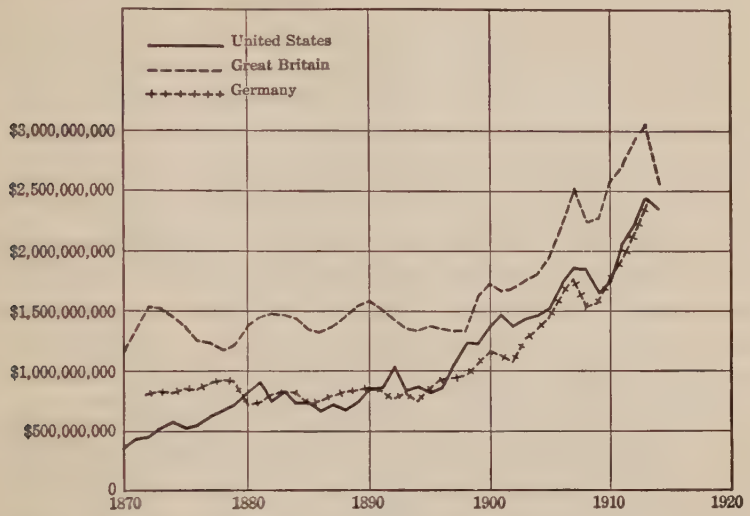


Chart 2. The Value of Exports of the United States, Great Britain, and Germany, 1872–1914

A study of this diagram indicates a pronounced growth in the export trade of all these countries. For Germany and the United States, this rapid growth continued throughout the period under review; for England, the export trade was much larger than was that of the other countries in 1872, but the rate of growth of British export trade was slower between 1872 and 1900 than was that of the trade of Germany or the United States. Considering the whole period, there was a tendency for the exports of Germany and the United States to approach the level of British exports, but it would be a mistake to assume that the trade of the latter country was stagnating. In fact, since the opening of the present century, British exports have increased by a greater proportion than have the exports of the United States, though somewhat less than those of Germany. This can be seen by a comparison of the exports of each country in the first four years of the present century with the exports of the same country in the four

pre-war years. If we take the exports of the years 1900–1903 as bases, *i. e.*, if we designate them as 100, then the exports of Great Britain in the years 1910–1913 will be represented by the index number 164, the exports of the United States by 148, and the exports of Germany by 177. If, on the other hand, we compare the exports of 1913 with those of 1872, we find that the gain of the United States was by far the greatest. United States' exports advanced between 1872 and 1913 in the proportion of 100 to 555, British exports from 100 to 201, and German exports from 100 to 296. Briefly, then, if we go back forty years before the recent war we find that Great Britain held a pronounced lead over the other exporting countries. It still held a lead in 1913, although that lead had been considerably reduced by the rapid strides of the United States and Germany.

The upward and downward swings in the course of the export trade of the three countries shows a rather marked correspondence. This suggests that the cyclical movements in a country's foreign trade are, to a considerable extent, the results of conditions common to all trading countries and, therefore, quite beyond the control of the individual country.

The Nature of American Exports and Imports

Some of the most significant tendencies in our foreign trade are found in the changes in the nature of our exports and imports. These changes, in turn, reflect the changing industrial position of the country. They indicate a shifting of the comparative advantage from the products of agriculture to those of manufacturing. The tendency can best be appreciated by classifying our exports according to the nature of the products and tracing the development of each class of exports throughout our history. Five groups are distinguished. Group A comprises crude materials for use in manufacturing. The most important item in this group is manufactured cotton, which accounts for about 75 per cent of the value of the whole group and is, in fact, the chief of all our exports. Group B includes foodstuffs in crude condition, chief among which is wheat. Group C includes food-

stuffs wholly or partly manufactured. Leading in this list are the products of the meat-packing establishments and wheat flour. Group D comprises manufactures for further use in manufacturing and includes copper in various forms, and iron and steel products. Group E, manufactures ready for consumption, includes a great variety of articles, no one of which stands out above the others as do the few products mentioned above in their respective groups. Important items of this group are refined products of the petroleum industry, agricultural implements, automobiles, machines of various kinds, and cotton cloth. The specific articles mentioned are those which now play a large part in their respective groups. The groups may have been made up of other

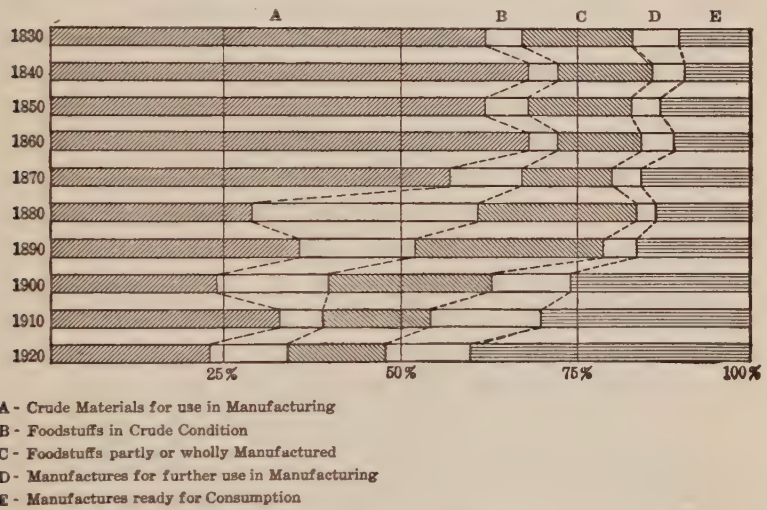


Chart 3. Merchandise Exports from the United States by Groups of Commodities, 1830–1920 (Per cent of total exports)

articles in earlier times. In this sense these groups are not strictly comparable from decade to decade. But such a comparison will show whether or not there has been a distinct change from goods exported in their crude form to more highly fabricated products. Chart 3 shows the distribution of our exports among these groups in decennial years from 1830 to 1920.

The most striking facts indicated by this chart are the marked and consistent decline in the relative importance of raw materials (Group A) and the increasing importance of manufactured goods ready for consumption (Group E). The declining importance of raw material exports has been occasioned by the fact that as the country has developed, a smaller proportion of our energies has been devoted to producing these goods; and, further, that a large part of the raw materials produced has been absorbed by our domestic industries. Nevertheless, raw materials still constitute a very important part of our exports. The decline has been relative, not absolute. That is, exports of raw materials have increased throughout our history, but they have increased more slowly than have some of the other groups. They no longer hold the predominant position which they occupied in 1870. The most pronounced break occurred between 1870 and 1880. Group B, foodstuffs unprepared, which includes principally wheat and other cereals, passed from relative insignificance, in 1830, to a more important position, about 1880. Since that time, however, and especially since 1900, they have declined in importance. In this case the decline has been not only relative but absolute. The value of exports of this class was actually less in the years around 1910 than in those around 1880, while our total exports had more than doubled.

The increased exports of grain about 1880 were a reflection of the opening of the great region west of the Mississippi by the railroad development of the two decades preceding. This led to a rapid settlement of cheap land and provided an outlet for the produce of the region. Much of this produce was, in a sense, a by-product of land speculation. The land was occupied and tilled, not only for the produce itself, but in the hope of profits to be gained by advancing land values. These and other factors combined to create a supply of crude foodstuffs, far in excess of the needs of city dwellers in this country, and the surplus flowed abroad. Since then our manufacturing and other city employments have increased so much more rapidly than the agricultural output, that an ever smaller part of this out-

put has flowed abroad. It has been a case of increasing domestic demand rather than one of decreasing supply.

The decline of this class of exports has been more pronounced than even those of Group A, and we may hazard the prediction that it will be carried even further. Group C, food in a prepared state, has passed through a somewhat similar cycle, although its decline has not been so pronounced. Flour milling and the other food-preparing industries were not stimulated by the opening of cheap lands as much as was the production of the farm products. Hence the export of goods of Class C did not increase so much, nor has it declined so much, as has the export of food in unprepared form. The processing of foodstuffs is a manufacturing industry. Furthermore, it is an industry employing large-scale methods and a considerable amount of capital. It would appear, therefore, that there is no reason on the manufacturing side why it should decline in this country. The decline of exports of this class is to be explained by a lessening of our comparative advantage in producing the materials, not in their preparation.

Prior to 1880 the rôle of the United States in the scheme of international division of labor was to supply the industrial countries with foodstuffs and raw materials; since then our manufactured goods have assumed a position of ever-increasing importance. This new tendency reflects a change in our domestic economy which, in turn, has been caused by the development of new and better technical methods of production, more effective organization of our industry, and a more plentiful supply of capital. Our effectiveness of production in these lines has increased more rapidly than in the more elementary industries. Effectiveness of production in these latter industries has not declined, but modern developments have merely placed them at a disadvantage compared to manufacturing. That is, there has been a shifting of our comparative advantage from the one group of industries to the other. The consequences of this development are discussed incidentally in other places. Here we can briefly note two of them: (1) It has brought us into direct

competition with those countries (principally those of Europe) whose industry we had in the past merely supplemented. (2) The sale of manufactured goods has required more active selling efforts and more elaborate sales organizations than did the sale of the staple products of the farm. These results help to explain the greater attention given to our foreign trade in recent years and the increasing rivalry with the great commercial and industrial countries.

In the following diagram the data of Chart 3 are rearranged to contrast sharply the relative importance of exports of raw materials and unprepared food, on the one hand, and all other products either wholly or partly manufactured, on the other.

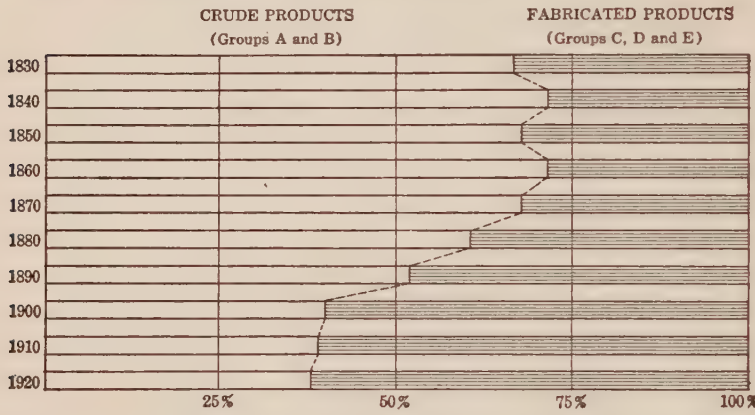
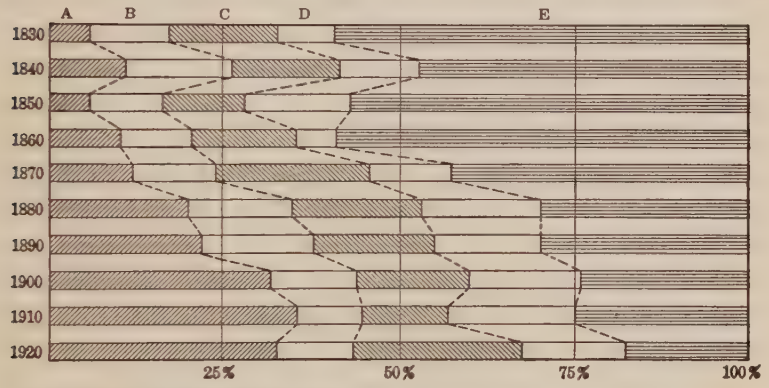


Chart 4. Exports of Crude Products and Fabricated Products from the United States, 1830–1920 (Per cent of total exports)

These tendencies in the nature of our exports were working themselves out gradually up to 1914. The effect of the war upon the nature of our exports as well as upon the total amounts was profound. One of the most marked tendencies which we have noted, that of foodstuffs to decline both absolutely and relatively to other products, was quickly reversed. Raw materials, on the other hand, which had been holding a rather constant position, declined sharply in relative importance. Manufactured goods, which had been gradually assuming a more important

position, increased greatly. That is, some of the tendencies were reversed while others were abnormally stimulated. In the years since the armistice there has been, generally speaking, a tendency to return to the pre-war character of our exports. Thus, manufactured goods ready for consumption, which in 1914 made 31 per cent of our exports, rose to 47 per cent in 1916 but by 1921 were back to 37 per cent. Raw materials fell from the pre-war level of 34 per cent of our exports to 11.7 per cent in 1917 but in 1921 were 22.5 per cent.

The pre-war tendencies are likely to continue even after the disturbances of the war, for they rest upon the fact that this



(1) For definition of groups see note to chart 3.

Chart 5. Merchandise Imports into the United States by Groups of Commodities, 1830–1920 (Per cent of total imports)

country is becoming more distinctively industrial and less distinctively agricultural. This seems to be the manifest destiny of this country. For the present, however, we cannot disregard the possibility that attempts of the European countries to meet their obligations may lead to increased competition in the exports of manufactured goods to the markets in which we are selling.

In our merchandise imports we find another reflection of these changes in our international position. The changes in the nature of our imports are portrayed in Chart 5, in which the same

classification of commodities is employed as was introduced above. Generally speaking, the tendencies here indicated are the reverse of those observed in our export trade.

The most striking feature in the nature of our imports has been the marked decline in the relative importance of manufactured goods ready for consumption and the increased importance of raw materials for use in manufacturing. We find the first clear evidence of the change in trend of our exports in 1880, and that year was likewise the dividing point in the trend of imports. In that year manufactured goods were about 29 per cent of our total imports as compared to 40 per cent in 1870, while raw materials accounted for 20 per cent as against 12 per cent in 1870. The movements originating in that decade have continued on to the present. The two tables, the one for exports and the other for imports, serve to emphasize both the increasing importance of manufacturing in our national economy and the very recent development of this tendency. Foodstuffs, prepared food, and manufactured goods for further use in manufacturing have held their relative positions in our imports throughout the history of our commerce. This fact, of course, means that they have grown apace with the growth of our total imports. We may safely look for this growth to continue. There are, indeed, some who look for a marked proportional increase in food imports. This prospect, no doubt, is suggested by the analogous developments of the imports of Great Britain as it progressed to its industrial status. But the agricultural resources of this country are so great that one would have to project his imagination a very long way into the future to vizualize a dependence of this country upon foreign sources for necessary foods. In fact, the increasing import of foods is accounted for by the foreign purchase of such products as sugar, coffee, tea, cocoa, tropical fruits, tobacco, and similar products, which indicates, not a shifting from domestic to foreign sources of supplies, but an increased consumption of semi-luxuries.

The Direction of American Foreign Trade

We now turn from the nature of our exports and import to the direction of our trade—the destination of our exports and the sources of our imports. First, we shall note the distribution of our exports between the grand divisions of the world. This is portrayed in Chart 6.

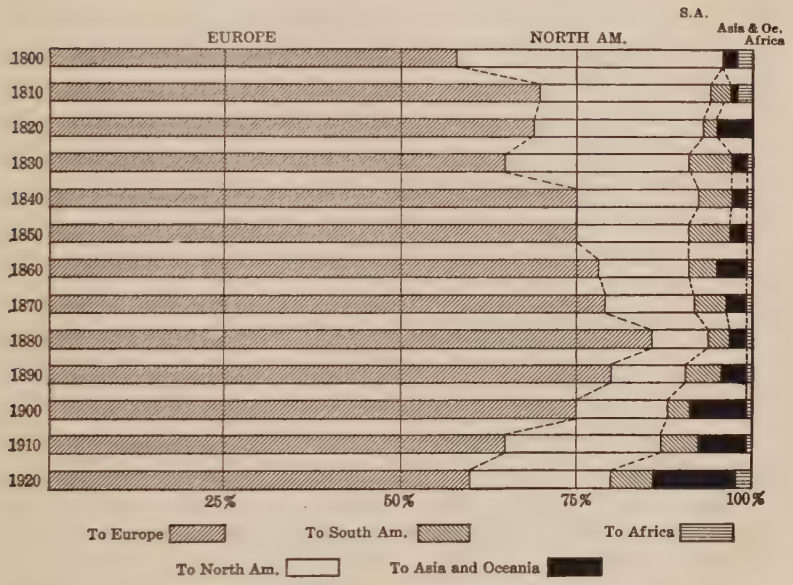


Chart 6. Destination of Merchandise Exports of the United States, 1800–1920 (Per cent of total exports)

It will be noted that from the very beginning Europe has been the chief purchaser of our products—that, in fact, it has always taken more than all other parts of the world combined. But the proportion of our exports taken by Europe has been declining since 1880. Again we see that this year marks the beginning of the new trend. This is, of course, more than a coincidence. As long as our exports were preponderantly agricultural products, it was only natural that they should flow almost entirely to those manufacturing countries which demanded

foodstuffs and materials beyond their capacity to produce them. Now that our manufactures are playing a large part in the export trade, we find a somewhat larger part of our market in other lands. Much has been made in recent years of this relative decline of the trade with Europe and the corresponding increase of trade with other lands, especially with the less industrially advanced countries. The tendency has been exaggerated in the popular view. A moment's study of the preceding graph will indicate that these "new" countries, South America, Asia, Oceania, and Africa, still occupy relatively unimportant positions in our total export trade. The importance of South America as a market for our exports has been especially emphasized; but South America has never taken more than 7½ per cent of our exports. Even in the purchase of manufactured goods, which some people assume must be sold to the nonmanufacturing countries, Europe holds a prominent position. The year 1913 will serve to illustrate.

TABLE 14. EXPORTS FROM THE UNITED STATES OF MANUFACTURED GOODS READY FOR CONSUMPTION (1913)

To North America	$302,000,000	39%
To Europe	239,000,000	31%
To Asia and Oceania	118,000,000	15%
To South America	100,000,000	13%
To Africa	17,000,000	2%
	$776,000,000	100%

The notion that trade between industrially advanced countries and the more backward countries is more natural than that between the industrial countries themselves, is subject to very serious qualification, if, indeed, it be tenable at all. Manufactured goods are purchased in large volume only by those countries which have a large population with a relatively high income level and high standard of living. These conditions are found in the manufacturing countries themselves. This fact apparently counts for more than the fact upon which the opposite view is based: that backward countries must necessarily import what-

ever manufactured goods they consume. The demand for manufactured goods is, on the whole, more influenced by the purchasing power and standard of living of the purchasers than is the demand for foodstuffs. This is especially true of such goods as automobiles, talking machines, bicycles, typewriters, cash registers, gasoline, and the other goods which form such a large and increasing part of the products of modern industry. For such products the manufacturing countries themselves furnish the best markets. This is often true even when the specific countries are producing products of the same sort as other countries are selling. For example, the United Kingdom is an important producer of sewing machines but, while it exported in 1913 sewing machines to the value of $11,500,000, it bought sewing machines from the United States to a value of $3,016,898, leading all other countries as a purchaser of this product. Although this is an exceptional case it is not unique. A country with a high standard of living, such as that usually prevailing in modern manufacturing countries, is likely to have a varied, discriminating, and widespread demand for manufactured goods. Such a demand leads to purchases from other industrial countries.

This view is borne out by an examination of the exports of the European countries as well as those of the United States. It can be stated as a general proposition that the trade of the European countries among themselves is more important (larger) than their total trade with the various new markets for which they engaged in such keen commercial rivalry. Germany and France were among England's best markets and England, in turn, was the best market for both Germany and France. Not only is this true at present, but it is likely to continue to be true even if the industrial countries continue to increase their output of manufactured goods.

All this is by way of caution against the extreme conclusions commonly drawn from the foregoing table. We can safely say that the tendency since 1880 has been for the European countries to take a relatively smaller share of our exports and for the non-European countries to take relatively larger shares, and that this

tendency may continue for some time. But Europe is still our best customer and there seem to be sound reasons for thinking that it will long maintain that premier position.

The war temporarily reversed these tendencies in the direction of our trade as it did in the nature of the trade. The exports to Europe, which had been tending toward a less predominant position in our total trade, increased sharply in response to the demands of the belligerent countries for food and military supplies. Since 1919 they have declined in relative importance. Likewise, the exports to North America, which were tending upward prior to the war, fell off in relative importance during the war but have now increased again. Broadly speaking, we can say that the tendencies in the direction of our export trade discernible in pre-war days were temporarily interrupted, but that the present allocation of our exports between the grand divisions of the world is about what it would have been had the pre-war tendencies continued to operate without interruption. One interesting exception is that of exports to Asia and Oceania, which for several years before 1913 had stood at about 7 per cent of our total exports, but which in 1919 were 11 per cent, in 1920, 13 per cent, and in 1921, 14 per cent. The United States has gained a foothold in the Far East which it is not likely to lose entirely with the return of the European countries to their normal trade.

Chart 7 shows the changes in the values of exports to the several divisions of the world from the corresponding amount in 1913. The heavy line indicates the trend in the value of total exports. The most noticeable characteristic of the curves is that, starting from the same point in 1913, they diverge widely during the war and immediate post-war period but that now they are coming back to nearly the same point, with the exception that Asia and Oceania remain far above the index for total exports. It thus emphasizes the observation made above, that our export trade is rapidly returning to its old channels.

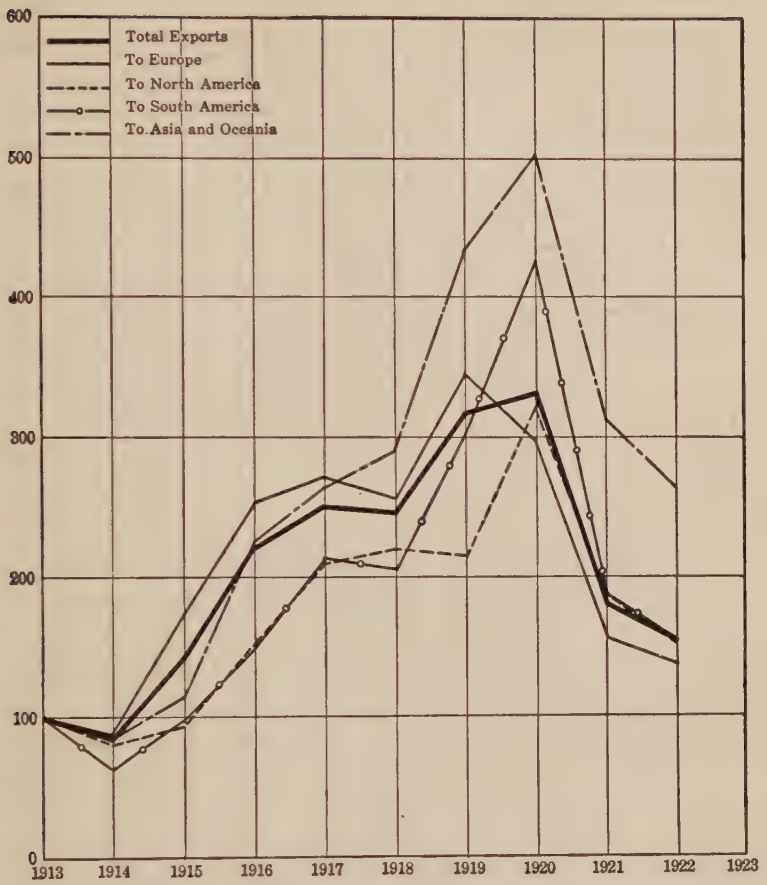


Chart 7. Changes in United States Exports to the Grand Divisions of the World, 1913–1922 (Index numbers—exports of 1913 = 100)

Great Britain has had a somewhat similar experience. The direction of its exports were radically changed during the war, but in the last few years they have shown a marked tendency to return to the old lines. In pre-war days British exports were divided, according to destination, into three approximately equal parts: (1) those going to Europe, (2) those going to the British Empire, and (3) those going to other non-European countries, chief among which was the United States. By 1919, the

proportion going to Europe increased to 55 per cent of the total, but it is now back to the pre-war figure. The proportion going to the Empire fell to about 26 per cent of the total in 1919 but in 1922 returned to about 39 per cent of the total.

There was no such marked change in the sources of our imports between 1880 and 1910 as we found in the nature of those imports. Table 15 indicates the proportion of our total imports coming from the several divisions of the world.

TABLE 15 SOURCES OF IMPORTS. PER CENT OF TOTAL

	Europe	North America	South America	Asia and Oceania	Africa
1885–1894	53	20	13	13	1
1895–1904	52	17	13	17	1
1905–1914	50	20	12	17	1
1915–1919	23	30	18	27	2
1922	32	27	11	28	2

Although raw materials and foodstuffs were playing an increasingly important part in our imports, and manufactured goods a correspondingly less important part, it was still true in 1910 that over one-half of our imports were coming from Europe. This was in part due to the fact that a large part of those raw materials which were mainly non-European in origin were imported through the European markets. Certain European centers, London and Amsterdam and others, were recognized as the great central markets for many of the materials gathered from the backward countries of the world. Among the products so imported were rubber, tin, tea, wool, and some kinds of tobacco. Much has been said about the waste of effort involved in transporting these goods to Europe and then to this country. But under some conditions it may well be justified. The European centers were large buyers of these products for their own consumption, and they were taking large quantities of at least some of these products before our demand for them became important. Therefore, markets were established with the equipment for handling and storing the goods; banking and the commercial system were adapted to trading in them; and transportation facilities were

provided. These products can be most economically handled and exchanged in large quantities, and this fact may often be sufficient to overbalance the advantage of the shorter haul which would be possible if they were sent direct from the producing to the consuming countries.

During the war, however, there was a great increase in our direct trade. This was due to a number of factors. The demand for these goods in the United States increased greatly, and the large volume of imports made direct handling more feasible than it had been before. The mobilization of the industry of the Allied countries for purely military purposes and the closing of markets of the Central Powers combined to reduce greatly the demand of the European countries for these products. The danger of ocean transportation in the war zone and the resulting high insurance rates forced the utilization of new channels. These and other factors growing out of the war led to a great change in the direction of our imports.

This tendency to more direct trading has shown its effects on British trade as well as on our own. Before the war some 21 per cent of British exports were reëxports. This dropped to 6 per cent in 1918 and since 1920 has stood around 13 or 14 per cent. The United States was only one of several countries purchasing these reëxported goods, and there has not been the growth of direct trade on the part of Britain's other customers which has characterized recent American imports.

It is difficult to say how far this change to more direct trade will be permanent. There are already some evidences of a reversion to the old trade routes and methods. For example, Sumatra tobacco which, prior to the war, was imported through the Netherlands, is again coming from that country after a brief period of direct imports during the war. [1] But our consumption of rubber, tin, and some other products now forms such a large part of the total world consumption that it is doubtful if the European markets will entirely regain their old position in these more important products.

[1] *Commerce Monthly*, Vol. 4, No. 4, p. 10.

CHAPTER VIII

THE MARKETING FUNCTIONS IN FOREIGN TRADE

When the student of foreign trade approaches that part of the field which has to do with the actual machinery of exporting and importing he is confronted by a multitude of middlemen, functionaries, and methods. His difficulty is increased by the fact that middlemen designated by the same name often perform widely different functions. It will help to clarify the subject as well as to throw light upon some specific questions if we center our attention upon the tasks to be performed, rather than primarily upon the middlemen or others who perform them. With this purpose in mind, we shall break down the larger problem of marketing goods into its constituent parts. These we designate as marketing functions. These functions will be found to exist in the selling of all kinds of goods and occur whether the operations be performed by one middleman or another or by the producers or consumers themselves.

The functions of marketing involve all those tasks which have to be performed in getting the product from producer to consumer. They may be grouped into (1) buying and selling functions, (2) functions of physical supply, and (3) auxiliary or facilitating functions. The first group has to do with the exchange of goods or the transfer of ownership. This includes the creating of a demand, which is exemplified by salesmanship and advertising. For many commodities it is the most expensive and difficult function in the whole distributing process. The functions of physical supply involve the actual handling and preservation of the material goods. The facilitating functions are those which are necessary to the distribution of goods and still do not directly advance the product on its way to the consumer. The functions of risk-assumption and financing are included in this group.

THE MARKETING FUNCTIONS [1]

A. Functions of Exchange
   1. Assembly (buying)
   2. Demand creation (selling)
B. Functions of Physical Supply
   3. Transportation
   4. Storage
C. Auxiliary Functions
   5. Finance
   6. Risk-taking
   7. Standardization

Some of these functions will be discussed in other chapters, but it is well here to introduce all of them in order that we may have the whole marketing task before us at the outset.

THE EXCHANGE FUNCTIONS

Assembling.—This term is used here in a special sense. It refers to the buying side of an exchange, and still it implies something more than the mere act of buying. It involves all those acts which are necessary to seek out sources of supply and transfer the ownership of goods to the buyer.

This function, like many of the others, is more difficult of performance in our modern system of industry than it would be under a simpler system. This difficulty occurs because production is so specialized that one producer can very rarely meet all the needs of any dealer and never of the consumer. There is, therefore, a very burdensome task of bringing together from the many sources of supply the goods desired and in just the quantities desired. Dealers who make a business of serving final consumers may perform the function themselves, or producers may each attempt to reach all the retailers. Both these plans are used in practice, but ordinarily it is found more economical for both retailers and producers to rely upon middlemen who specialize upon the performance of this function. It is remarkable that the principle of specialization, which receives such universal approval when applied to the production of goods, should be viewed

[1] F. E. Clark, *Principles of Marketing*, p. 11.

in a quite different way when applied to the distribution of goods. Specialization in the function of assembling is even more important in foreign trade than in domestic trade, for retail distributors and consumers are separated from producers by greater distance; communication between them is more difficult, different languages and different monetary systems are used, and the volume of purchases from any one region is likely to be smaller than in the domestic trade. All these considerations make it especially important that the foreign dealer should have specialists to look after "assembling" in the technical sense of the term which we are employing as well as in the sense of bringing together the physical product for more economical transportation.

The broker furnishes an example of one who performs the assembling function. He earns his income by keeping himself informed on the sources of supply of one product or of a group of products. The prospective buyer is willing to pay for the broker's services in putting him in touch with possible sellers and finding those sellers who will give the most advantageous prices. The export commission house, to be discussed in detail in the next chapter, also performs this function. One of the principal tasks of the commission house is to buy relatively small quantities of a large number of goods for foregin buyers. It also performs other functions, such as financing and looking after transportation, but these could be delegated to other middlemen with greater facility than could the assembling function. That there is a real function performed here can readily be seen by considering the task which the foreign buyer would assume if he were to do the work himself. It would be necessary for him to correspond with perhaps dozens of American manufacturers and to become acquainted with the price fluctuations of many commodities in the United States. If his purchases are large it may pay him to do these things, but it will be expensive and most foreign purchasers will find it better to let a specialist do this work for them. It is thus clear that the function and the expense attached to its performance cannot be eliminated by an elimination of the men who normally do this work. Many other middlemen as well as producers and

buyers of products in foreign trade have the performance of this function as one of their duties.

Demand Creation.—This is the selling function. It involves the task of bringing the product to the attention of the prospective buyer and of presenting it in the most attractive light possible. The importance and difficulty of the performance of this function vary greatly between different commodities. In the case of such products as wheat, raw cotton, and steel rails, the task is much less difficult than it is with jewelry, men's and women's garments, and electric washing machines. It is most important in products having a marked style element, or in new types of products, for here a considerable amount of education is required. On the other hand, it is of less significance when the product is thoroughly standardized and graded and also when the product is to be used for strictly utilitarian purposes. For example, there is little opportunity for profitable use of expensive advertising of steam coal. A purchaser will select such a product solely on the basis of tests and price. Tests can be applied because the utilities which one desires from coal are relatively simple and the capacity of the product to yield these utilities is measurable. But in the purchase of a pleasure automobile the task is not so simple. Besides durability and economy the buyer wants good appearance. Just how much good appearance should weigh as compared to the other factors is difficult for him to decide, and he is even open to suggestions as to what constitutes good appearance. Here then, there is an opportunity for effective demand creation in the form of salesmanship and advertising.

A further contrast based on these two products may be warranted. Not only can a demand be created for the one, but, when created, the manufacturer can be sure that he will reap the benefit of it. For automobiles differ from one producer to another, and a demand can, therefore, be created for a particular make of car. Some coal differs from other coal, but the differences are expressed in grades that are applicable to coal produced by all mines. Likewise one grade of wheat differs from another, but wheat of a certain grade produced by Brown cannot

be distinguished from the same grade of wheat produced by Jones.

These observations suggest some of the differences which distinguish the marketing problem for raw materials from that for manufactured specialties. The methods employed for the two classes of goods are widely different. For the former there is a long chain of middlemen highly specialized both as to type of goods handled and functions performed. For the latter there is a tendency to a shorter line of middlemen and, in the case of some products, to a direct contact of producer and consumer. There are several reasons offered for this tendency, but the chief one seems to be that for the latter type of goods demand creation is both important and feasible; and effective demand creation requires an active interest on the part of the producers. In the wheat and cotton trade buyers are as likely to take the initiative as are sellers and, therefore, demand creation is neither necessary nor commercially profitable. In the sale of phonographs it is both necessary and profitable.

The distinction has been emphasized at this point, because it illustrates the great importance of the function under consideration in some lines and its absence in others. Further, it suggests that as American export trade changes, as it is now changing, from an export of crude materials to an export of fabricated goods,[1] the methods of trade are also naturally changing. There has been a great increase in the number of American salesmen in foreign markets. There is an increasing interest in the business of foreign trade. This interest is at least partly due to the fact that we are now actively selling goods whereas in 1880 goods were merely being bought from us.

For those manufacturers who do not care to perform this demand-producing function for themselves or who are estopped from so doing by their limited resources or limited volume of trade, there are numerous middlemen. Among these are traveling salesman handling several non-competing lines, commission houses which have taken on this function, and advertising agen-

[1] *Cf.* Charts III and IV, Chapter VII.

cies which offer their services in preparing and placing advertising in foreign countries.

The Functions of Physical Supply

Transportation.—This function, more than other in the marketing process, is performed by specialists. These include railroads in the country of export, trucking companies at the port of shipment, steamship lines, and railroads, and other means of overland transportation in the foreign country. Only a few observations need to be made on this point. First, the transportation function plays a larger part in the marketing process in foreign trade than in domestic trade. The freight charges are so large, both absolutely and relatively as compared with the value of the product, that a small difference in these charges may determine where the order shall be placed. Second, because of the material savings that can be made in ocean freights by combining several small lots of goods into fewer large shipments, there is strong incentive for using middlemen, who will be able to ship goods ultimately destined for several buyers under one bill of lading. Middlemen may be employed for this function alone, leaving the other distributive functions to be performed by the manufacturer, buyer, or still other specialized middlemen. An example of a middleman who gives much of his attention to this one phase of the transportation function is the freight forwarder, concerning whom more will be said at a later point. A third reason for the employment of middlemen between the shippers and the transportation companies is that the business relations between shippers and carriers are not so simple as in railroad transportation. Rates fluctuate and vary to such an extent that it is often desirable to employ some one versed in the business to make arrangements for shipping space.

Storage.—An ideal adjustment of production to consumption would be one by which production proceeded just rapidly enough to meet the demands of consumers. But this is impossible of attainment because in some industries production must be seasonal, in others the consumption is seasonal, and in all of them it is impossible to predict consumer demand upon which the de-

mand of dealers ultimately rests. Therefore, most goods are stored as produced, and requirements are filled from stocks. These reserves of goods may be maintained at the point of production or near to the consumers. The former plan is ordinarily more economical, but the latter may be used if considerable time is required for transportation from producers to consumers. This is more likely to be the case in foreign trade than in domestic trade. It is, therefore, a distinct advantage to have goods carried in stock in foreign ports. It is not commonly done because the expense is great and the consumer demand is uncertain. Some very large exporting manufacturers have established storage facilities at foreign ports, but for all except the very largest firms such a plan is not feasible. Export merchants (middlemen buying in one market in advance of orders and selling in another market) do perform this function, and the fact that they are able to do it economically is one of the advantages enjoyed by this type of middlemen. For some types of goods such storage near the market is almost essential.

For graded raw materials, storage is influenced by the requirements of finance. For this purpose it is desirable to have goods stored in warehouses which are independently owned, for then warehouse receipts can be made the basis of bank loans. Storage, then, is necessary for two reasons. First, it makes provision for the seasonal nature of production. In this case it is desirable to have the function performed by independent middlemen because this arrangement facilitates financing. Second, it is desirable to have storage facilities near the market because of the uncertainty of demand. In this case the function is often left to middlemen because the separate maintenance of stores by producers is in many cases too expensive to be commercially feasible.

Rearrangement.—This is a task having to do with the physical handling of the product, and, although it is not listed above as an independent marketing function because it is not always necessary, it nevertheless is sometimes an important phase of the process of distributing goods. The necessity for rearrangement arises from the fact that different units of sale

are convenient at different stages in the marketing process. Thus an agricultural product may be bought from the farmer on the basis of a certain price per bushel; it may then be sold to the wholesale trade in a unit of carloads or tons, sold again to the retailer in bushels, and to the consumer either in pounds or in quarts. The manufacturer may sell to a jobber in units of a case which includes perhaps ten gross. The jobber may sell to the retailer in units of one gross; and the retailer may dispose of the product in still smaller units to the consumer. This combining of goods into large units and the breaking up of the large units into smaller ones are the principal tasks of rearrangement. As remarked above rearrangement is not always necessary. For example, expensive equipment may be handled in the same units through all the marketing steps, but with groceries, shelf hardware, and many other goods, rearrangement of the unit of sale may be made as an incident to each transfer of ownership.

The Auxiliary Functions

Risk.—There are at least three kinds of risk present in marketing transactions: (a) the possibility of physical damage to the goods; (b) the danger of adverse price movements while the goods are in one's possession, and (c) the danger arising from inability or refusal of one of the parties to meet his obligations.

The risk arising from occurrences of the first class is usually shifted to insurance companies. In foreign trade this involves marine insurance, which differs so much from other forms of property insurance that producers and buyers often find it desirable to employ insurance brokers or middlemen, such as commission houses, to obtain this insurance for them.

The risk of price change is enhanced in foreign trade by the time intervening between production and final sale. The producer can sometimes shift the risk to the buyer by producing only upon order; or the buyer can occasionally shift it to the producer by a contract whereby the price paid is that prevailing at the time of delivery; or both may shift it to a merchant who buys at prevailing prices in one market and sells in another,

assuming the risk of price change in the interim. Still another possibility is that the owner of the goods may hedge against adverse price change (a process to be described later). In this event professional speculators and brokers must be employed. The risk of non-fulfillment of contracts is enhanced in foreign trade, both from the point of view of buyer and seller, by the lack of acquaintance of one with the other. This can be overcome if both deal with a known intermediary.

It thus appears that the risk function is, like the others discussed, sometimes borne by the manufacturer, sometimes by the foreign buyer, and sometimes by middlemen. In any event, it is a real burden and must be rewarded by profits or commissions.

Finance.—From the time the product is completed by the producer until it is placed in the hands of the final consumer, it is necessary for some one to bear the burden represented by the interest accruing upon the capital invested in the goods. The manufacturer may part with the goods and wait for his pay until the goods are finally sold to the foreign consumer. On the other hand, the foreign merchant may inclose payment with his order. In the former case the financing is performed in the first instance by the manufacturer, while in the latter case it is borne in the first instance by the foreign buyer. In both these cases it is common to shift at least part of the burden to the banks. But some traders, because of their large volume of trade and long established business or for other reasons, are in a better position to enlist the aid of the banks than are other traders or the producers themselves. For this reason there is often an advantage in selling goods to merchants, or through other middlemen, who will relieve the producers and buyers of this burden and will perhaps themselves shift it to financial specialists.

Standardization.—The buying and selling of goods is greatly facilitated by having the goods classified according to recognized standards. In most manufactured goods there is no necessary marketing function for bringing this about, for products are standardized in the very process of production. But with agricultural products and other raw materials, the production process

does not yield finished goods of uniform size or quality. These goods must, therefore, be sorted and classified according to commonly utilized standards. This classification may be very rough and only designed to facilitate the sale of goods by inspection at auctions, or it may be so accurate that goods can be bought and sold by description. When once the importers and exporters of wheat, for example, have become accustomed to dealing on a basis of grades, it is almost impossible for the product to be sold in any other way. Satisfactory grading requires that the task be performed by specialists of undoubted ability and undoubted impartiality.

Much of what has been said in this chapter is in anticipation of more detailed discussion at later points. But the bringing together of all these marketing functions will have been worth while if it impresses upon the reader the fact that importing and exporting involve a great deal more than the giving and obtaining of orders for goods, and further, that middlemen who perform certain or all of these additional functions are not parasites. Certainly eliminating middlemen does not eliminate the functions which they perform, and there is no *a priori* ground for assuming that such an elimination will "save the middlemen's profits."

American manufacturers, for the most part, export only a portion and usually a small portion of their total production. The foreign market is thus only a more or less important incident to their general business. Futhermore, foreign trade is beset with many difficulties and complications not present, or present to a less degree, in domestic trade. There is, therefore, more reason for leaving the details of trade to specialists in the former than in the latter case. This statement should not be construed as an unqualified indorsement of the indirect as opposed to the direct method of marketing. The indirect method has distinctive weaknesses especially as regards the performance of the demand creation function, but, on the other hand, there is no reason for viewing it as a crude and inefficient system, which should only be employed by producers whose resources are so limited as to preclude any other method.

CHAPTER IX

THE CHANNELS OF TRADE

Goods may be sold by Americans in foreign markets by either direct or indirect methods. In the many avenues which such trade may follow it is often difficult to draw a line of distinction between these two general methods. In some cases the American manufacturer does nothing more than manufacture the product and send it to an export house in New York when he receives an order from that house. This is an extreme but frequent case of indirect exporting. Indeed, such a manufacturer can hardly be said to be engaging in foreign trade. True, his goods ultimately reach foreign consumers, but he is hardly aware of the problems of that trade. On the other hand, some manufacturers send their own salesmen to the foreign consumers and retain control of the product until it passes into the possession of the foreign consumers. It may be that not even a foreign retailer intervenes. This is direct marketing in its extreme form, and in this form it obviously will be undertaken by only the largest and most substantial of American corporations. Somewhere between these extremes we must draw a line of distinction. For the sake of clearness of distinction we shall consider as direct trading any method by which the manufacturer and his salaried employees retain control over the product until it reaches the foreign market. There it may pass into the hands of a wholesale or retail house, which may or may not be an exclusive agent of the manufacturer. We shall consider as indirect marketing any method by which the goods are taken over by an intermediary before reaching the foreign country. In later pages we shall consider the problem of which of these methods should be adopted by any manufacturer.

The Merchant

One of the simplest methods open to the manufacturer in reaching the foreign market is to sell to an over-seas merchant. The merchant is a middleman who buys goods on his own account in one country and sells them in another country. He may be dealing in only one line of goods but often he does a general merchandise business. For example, a certain large company purchases a great variety of goods in the United States, maintains warehouses in this country for storing these goods before shipment, and ships them to at least one section of the world in its own vessels. In the countries of destination these goods are held in warehouses and sold at wholesale to retailers. This represents a very high development of the merchants' business. Rarely do these houses own their own ships, and it is not essential, though it is customary, for them to own extensive storage facilities. Often these merchants perform other functions. Thus they frequently handle goods in a similar manner, but with the trade flowing in the opposite direction, *i. e.*, buying in the foreign country and selling in the United States. In each country they may present themselves as both buyers and sellers.

The merchant is the oldest type of foreign trader. In the beginnings of England's commerce the merchant often owned his own ship or ships. Without having orders for his goods or perhaps without any very definite idea of who were his prospective buyers, he purchased a shipload of goods and fared forth to barter his goods in some foreign port for goods which would be salable in his own or a third country. It was indeed an adventure. To the uncertainty of finding a market and of the terms to be obtained in that market, was added the danger of capture by pirates or by the ships of hostile countries. The Astor fortune was built up largely in this kind of traffic as well as in the American fur trade. The products of the trade were first sold to dealers in London but later vessels were fitted out in this country, loaded with furs and other goods of comparatively low value here, and taken to China, where they were

more highly valued. There they were traded for silks and other Eastern products. These were brought back to the United States and sold, of course, at a great profit.

As the means of communication improved and the volume of trade increased, the possibility of acting as an intermediary between two markets having scales of values as different as those mentioned in the above illustration became less common. Trading was conducted on a narrower margin of profit. Hence the old adventurer gave way to the more orderly, if less romantic, procedure of modern commerce. Further, as new channels of marketing goods have grown up, the producer has tended to dispose of his goods through these, and the buyer has been encouraged to go directly to the foreign producer. Both these practices leave a smaller field for the merchant.

There are very few American export merchants who confine themselves to a strictly merchant business. Most American export houses, if they operate to any extent as merchants, do so only in certain lines which experience has shown must be carried in stock to be successfully sold. Some American goods have been carried into foreign markets by merchants of other nationalities. Before the war, certain German merchants maintained buyers in the country for assembling goods for shipment to Japan or other countries. On the whole, selling through merchants is less important in this country than it has been in the past, and less important than in many other countries at present. Export merchants are still an important factor in the foreign trade of England. These English firms have built up a good will in many parts of the world and thus are able to continue in competition with other middlemen whose methods are perhaps more in harmony with present tendencies.

The distinctive advantage of the merchant as opposed to other intermediaries, to be discussed presently, consists in the fact that he carries a more or less complete stock of goods at the foreign trade centers or ports. This carrying of stocks was almost essential as long as transportation and communication were very slow and uncertain. Improvements in these services

have made it less essential, although it is still an advantage to the buyers. The carrying of stocks is more important in some lines than in others. It is, for example, especially desirable with style goods, for here the time element is important. It is less important with staple goods and others which can be satisfactorily ordered from catalogs and samples.

The merchant is truly an international jobber. As such he offers the same advantages to buyers and sellers as do the domestic jobbers. Chief among these advantages from the buyers' point of view are the possibility of promptly replenishing retail stocks and the consequent possibility of reducing retail inventories, relative to total sales. On the other hand, the merchant, from the point of view of the manufacturer, has the same weakness as the jobber; namely, his desire to substitute his own brands and good will for those of the manufacturer. This is partly offset, at least in the case of the small manufacturer, by the economy of selling through the merchant and the wide distribution of goods attained.

The Commission House Representing the Buyer

The most important intermediary in American exporting, judged by the volume of trade, is the export commission house. It has been estimated that 70 per cent of American exports are handled by these middlemen. We find in export trade, as in domestic trade, that the lines of distinction between different types of middlemen are not clearly drawn. In the terminology of business, commission men and merchants are often confused, and naturally so, for middlemen of one type are constantly encroaching upon the fields of the others. However, a line of demarcation between merchants and commission men can be drawn.

The merchant is an independent middleman, buying and selling on his own account and anticipating the needs of his market. The export commission house, on the other hand, acts upon the request of the buyer. In recent years some of these institutions have been led by the competition for business to

buy goods before they have received orders for them. To this extent, however, they are departing from their regular form and are assuming the position of merchants.

There are two sides to the work of a commission house. On the one hand, it is a representative of the foreign buyer. This is its original function and still remains one of its important fields of work. It is the normal rôle of the commission house. On the other hand, many American manufacturers desiring to sell in the foreign market have established relations with export commission houses, intrusting the sale of their goods in certain fields entirely to these houses.

It is very common for the same house to act in these two capacities and sometimes in a third, that of a merchant buying and selling on its own account. The well-known difficulty of trying to serve two masters is not absent here. It partly explains the unpleasant relations which sometimes exist between the export house and its two groups of clients.

Enough has been said to suggest that the relative importance of these functions is often confused. For the sake of clarity we shall consider the export commission house, first, in its rôle of representative of the foreign buyer and, second, as the representative of the American seller. The reader should bear in mind, however, that in practice these two aspects of its work often overlap. The commission houses, through which American goods are purchased, usually have their headquarters in an American port and branch offices in the foreign countries which they intend to serve. From these branch offices solicitors are commonly sent out to call upon the foreign merchants. The development of the commission house business is carried much farther in some regions than in others, and the degree to which the house takes the initiative in reaching the foreign buyers likewise varies greatly from country to country.

The relation between the buyer and the commission house is defined by the order, commonly known as the indent. There are as many forms of such orders as there are of relations between buyers and export houses, but one characteristic common

to all of them is that the order authorizes or requests the export house to purchase goods for the buyer. For example, the first clause in a standard indent used in the trade with India states:— "We hereby authorize you to purchase and ship on our account and risk the whole or any portion of the following goods." The order may specify the manufacturers from whom the goods are to be bought, or it may merely specify the quality and type of goods, leaving the export house free to procure such goods from any manufacturer. An order drawn in the former way is termed "closed" while the latter is an "open" order. The placing of the latter type of order indicates upon the part of the buyer considerable confidence in the export house. Such an arrangement is more satisfactory in the purchase of staple goods, *e. g.*, cotton piece goods, than in the more complicated manufactured goods. In the latter class of goods, samples and manufacturers' catalogs are making it easier for buyers to specify manufacturers from whom goods are to be bought. To the degree that this is done (and the practice is increasing) the importance and strategic position of the export house is somewhat lessened.

The foreign buyer who places an "open" order is very likely unacquainted with American manufacturers, and the exporter's services are, therefore, indispensable to him. The export house is sometimes reluctant to enlighten him upon the sources of supply, and, therefore, sometimes insists that the manufacturer shall deliver his goods free of all marks which might disclose his identity. The export house may also try to prevent the manufacturer from learning the destination of the goods. As long as the exporter succeeds in both these efforts, he must be relied upon to bring buyer and seller together. This attitude is one of suspicion. It is quite comprehensible, and perhaps, in view of the tendency of manufacturers to eliminate middlemen, it is not altogether unfounded. Nevertheless, this suspicious attitude is a confession of weakness, and if the existence of the export house did in fact depend upon the success of such a policy, this intermediary would be ultimately doomed to failure. The attitude causes resentment and suspicion all around. Many manufacturers who fully

appreciate the importance of the export houses hold that this attitude must give way to wholehearted coöperation between producer, buyer, and export house. This seems to be a reasonable contention, for the whole tendency both in the domestic and foreign trade is for the manufacturer to pay greater attention to the sale of his goods. This does not necessarily lead to the elimination of middlemen, for it is quite possible to work out a plan by which the manufacturer and the trader can join forces to the advantage of both, but there is no gainsaying the fact that the manufacturer is determined to have a larger part in the sale of his goods.

Again, orders to export houses differ as to price stipulations. The buyer may be content merely to state maximum prices and leave to the export house the task of buying at the best prices obtainable. In this case the export house is rewarded for its services by a stated commission. When this arrangement is utilized, the export house is truly a local purchasing agent for the foreign buyer. Or, on the other hand, the price may be definitely stated and made to cover cost of goods, insurance, and freight. In this event the export house is expected to buy from the manufacturer at a price lower than that granted to the buyer by an amount large enough to yield a profit without any commission being paid. When the export house accepts such an order, it is in the position of a merchant who has "sold short," for it probably does not own the goods itself. The danger of such a procedure, however, is minimized by the fact that the order is not binding upon the export house until it has been formally accepted, and such acceptance will, of course, be conditional upon a reasonable degree of assurance that the goods can be obtained at a price which will show a profit. This assurance may be based on a long standing arrangement with manufacturers, or it may be based upon specific inquiries made after the order has been received.

In brief, then, the export house may accept orders from the buyers in foreign lands at prices fixed in the sales contract and with no additional commission, or it may be authorized to use its discretion (within limits) as to price and source of the goods,

gaining its reward by a commission paid by the buyer. Under the former arrangement its work is similar to that of the merchant, differing only in the fact that the merchant carries a stock of goods in anticipation of sales while the commission house does not.

To illustrate the work of the commission house in its capacity of representative of the foreign buyer, let us suppose an order to be received authorizing the house to buy goods of certain specifications for a dealer in India. The order has been taken by one of the branches of the export house in India and forwarded to New York, and notice of acceptance has been sent.

The commission firm now sets about its work of buying the goods and assembling them at New York. An order is sent to each manufacturer who is to supply a part of the goods directing him to send the goods to New York in care of the export house, packed ready for export shipment, and possibly labeled with a device which will not disclose to the manufacturer the identity of the final consignee. The manufacturer ships the goods to New York, notifying the export house and sending them a bill calling for payment in substantially the same way as would be required from any domestic purchaser. Some concessions in time of payment may be made in view of the fact that the goods are destined for export, but the manufacturer looks to the export house for his payment, and the obligation of the export house to pay is not dependent upon its ability to collect from the foreign buyer nor upon the safety of the goods after their arrival in New York.

When all the parts of the order are assembled in New York, the exporter takes out insurance on the goods, engages shipping space, and fulfills the necessary consular requirements. In these matters he may be acting in his own capacity or as an agent of the foreign buyer. If the order has been accepted on a C. I. F. basis—that is, if the price quoted is to include cost of goods, insurance, and freight to the destination, he will be acting as an independent middleman. If, on the other hand, the price is F. O. B., New York, the buyer will have to pay the insurance and freight, but the exporter will be expected, nevertheless, to engage

these at the most favorable rates and to advance the payments for them, looking to his foreign client for reimbursement. Upon arrival at the branch house in India, the goods are delivered, and the buyer makes payment either upon acceptance of the goods or within a specified time.

Besides acting as buying agent for the foreign merchant, the commission house is often his selling representative. Many foreign merchants, especially where the trades have not become specialized, are not only importers of American goods but also act as collectors of the raw materials of their district and export these to the United States. In this side of their business they often turn to the export commission house for assistance.

The Commission House Representing the Seller

We now turn to the commission house as a representative of the manufacturer. The American manufacturer often receives his first introduction to the export commission house in the form of a request for prices and terms, followed, perhaps, by an order for export. A sale has been made with no selling expense to the manufacturer; payment is prompt; it is a sale outside his natural field and hence a clear addition to his volume of trade. As these orders continue to come in from time to time, he begins to consider the profits to be made by giving more serious attention to this part of his trade. It is only natural that he should go to the export house and propose that it make a more definite effort to develop a demand for his products. Since the export house already has its branch houses established and perhaps its salesmen in the field, and has a rather definite clientele, it is likely to consider this proposal favorably. Thus it has come about that export houses have assumed the representation of American firms in many parts of the world.

The arrangement between the manufacturer and the export house may call for a consignment of goods to the export house to be sold at the best prices obtainable or at prices specified by the manufacturer, a definite rate of commission on all sales being paid by the manufacturer. On the other hand, the export house

may merely solicit orders in its own name but with the understanding that the manufacturer is to supply the goods to the export house at a special discount. By the former plan the export house is analogous to the domestic commission house, and under the latter plan it resembles the domestic jobber except that the jobber carries a stock and the export house does not.

The manufacturer, having established relations with an export house, may leave the sale of goods in foreign markets entirely to that house or he may himself assist by the distribution of catalogs and samples. Sometimes the manufacturer sends his own salesmen into the field, at least at the outset, to help in introducing his goods. The export house has the advantage of intimate knowledge of the field, while the manufacturer, of course, is superior in his knowledge of the product and the most effective arguments in selling it.

Very often these arrangements are exclusive within particular regions, *i. e.*, the manufacturer agrees that only the one export house shall be permitted to sell his products in that region. In any event, but especially when an exclusive agency agreement is contemplated, great care must be used in selecting an export house. There are a great many such houses in this country and they are of all degrees of reliability. Many of these make a specialty of supplying goods to certain countries. Others specialize not only as to districts covered but also as to classes of goods handled. Even those large companies which reach out to nearly all parts of the world are much stronger in some regions than in others. There is no export commission house in the United States which stands preëminent in trade with all parts of the world. Hence the manufacturer may do well to assign Argentina, or perhaps only a part of that country, to one exporter, and possibly Brazil to another. Some considerations other than the standing of the firm in the district in question are: the financial responsibility of the export house, the number of other products handled which will take the exporter's time and attention, its willingness to look after details of shipment, its willingness and ability properly to distribute the manu-

facturer's advertising matter, and the rate of commission demanded.

Sometimes manufacturers aim to sell to any or all export houses without entering into a definite agreement with any of them. A discount is given on all sales to such firms as it is to any wholesale establishment. For the purpose of making sales of this kind another middleman is sometimes employed known as the export agent. This export agent exists primarily for selling, and his principal field is with the export commission houses, export merchants, foreign buyers, and other purchasers of goods for export at the principal port of the manufacturer's country. There are many of such middlemen in New York, and the export agents of Hamburg have formed an especially important link in the German export system. These agents ordinarily handle the products of several manufacturers. They fill a quite different place than do the export houses, for they are primarily engaged in selling while the latter handle practically all marketing functions. When the export agent is employed, the chain of distribution can be represented thus: manufacturer—export agent—export commission house or merchant—foreign dealer—foreign consumer, except that the goods may pass through the hands of several foreign dealers before reaching the final consumer.

Advantages of the Indirect Method

We are now in a position to state more explicitly the services rendered by the export houses to buyers and sellers. We will first consider the subject from the point of view of the buyers or importers, assuming that they are foreigners buying American goods. The most important service is that of the assembling or concentrating of the goods in the country of origin. Distributors in foreign countries ordinarily require a variety of goods. They cannot keep in touch with the many manufacturers of these goods in a distant country. If the manufacturers themselves do not take the initiative, the buyers must themselves employ some agent to handle their purchases. If they were making as large purchases as some of the large department stores

or railroads, they would very likely maintain a salaried purchasing agent in those markets where they purchase their goods. This would obviously be impracticable for any but very large buyers. But the commission house by serving many buyers can act much as would a coöperative purchasing agent and still keep the cost of the service low enough to bring it within reach of relatively small importers. This service is of less importance to those importers who are buying the goods of only a few producers.

Not only does the commission house undertake the work of buying the desired goods but it enables the foreign buyer to deal with an institution of known standing, whereas the producers themselves are often unknown in foreign countries. Thus the risk of fraud or failure to fulfill contracts is greatly reduced. The buyer is able to give very general directions, allowing the commission house to exercise its own judgment to a considerable extent. This is not always done, but examples are frequent enough to indicate that it is feasible. Just how useful the export house will be in this way depends upon the relations established in particular cases, but it can serve in many ways other than in the mere carrying out of the buyer's specific orders.

A more specific service is that of financing purchases. Manufacturers often ask for cash with the order in the sales of small quantities of goods to unknown buyers. The export house is able to extend credit on a whole order of goods at reasonable rates. The export house commonly shifts this function, in part, to banks, but even in this it is an essential intermediary.

The transportation function is likewise more economically performed through the activities of these houses. There is a considerable saving in ocean freight rates when goods are sent in large quantities rather than in many small lots. The export house not only can combine all the goods going to one buyer but can ship as one lot the goods destined for several buyers at the same port. The shipment is divided and distributed by the representative of the export house at the port of destination. The goods may be sold on a basis which calls for the freight bill to be charged as a separate item to the buyer or this bill may be included

in the price quoted. In either event it is finally paid by the buyer of the goods. The saving in freight effected by the export house often exceeds the total commission fees. The export house looks after insurance, trans-shipment, entering of goods, and temporary storage at the foreign port, and other details which are much more burdensome in foreign than in domestic commerce.

The commission house also performs services of real value to the American manufacturer. In the first place it performs the demand-creation function. Its efforts along this line may consist merely of keeping on file in its foreign offices the catalogs of the manufacturer, or it may send out its salesmen with the manufacturer's samples. Of course, it will be handling the products of other manufacturers at the same time but nevertheless a considerable demand may be aroused by this method. In this respect the exporter's service to the manufacturer is analogous to the services of the jobber in the domestic market. More sales would probably be made by the manufacturer's own representative although even here the greater efforts devoted to one line may be partly offset by the lack of knowledge of the market. The commission house has its men in the field. The cost of maintaining them is spread over many lines of goods. This method is in effect similar to a coöperative selling agency. The manufacturer, on account of this division of costs, will be able to reach a wider market than he could hope to cover with his own men. We may say that the indirect method of reaching a market through a commission house leads to an extensive development of the market, while the direct method insures an intensive development.

The other services to the producers were implied in the discussion of services to the buyers. They involve caring for transportation and otherwise assuming responsibility for the physical distribution of the goods, assuming some risks, and financing the transaction. The last is especially important to American sellers of limited resources.

The chief advantage of export houses from the point of view of the producer of the goods is their low cost of distribution. This economy arises in part from the fact that these organizations

specialize upon distribution but even more from the fact that they combine, both as to selling and as to physical distribution, the products of hundreds of producers, and thus reduce the expense chargeable to each. Now in any business, economy in distribution expense as well as in expenses of production is of prime importance. It appears, therefore, that rather than view the indirect method as exceptional and to be justified by the limited resources of the producer, we should consider it as the normal method of conducting export trade. Under special circumstances producers may decide to eliminate the established export houses and go direct to their market, but this is a later historical development as well as logically an exception to the normal method of dealing through specialized agencies. It is, however, a policy which in recent years has been adopted by many producers. We, therefore, turn to a consideration of the conditions which favor the direct methods.

Conditions Favorable to the Direct Method

The conditions favorable to the direct method are found in certain characteristics of the producer, of the product, and of the market. The first condition, without which none of the others can be effective, is large financial resources on the part of the producer. These are necessary in order to set up and maintain a sales organization. Salesmen's expenses must be paid, and these are commonly much higher in foreign trade than in the domestic trade. If the middlemen are to be eliminated entirely it is often necessary to establish warehouses or otherwise provide for storage and physical handling of the product. Further, considerable capital must be tied up in accounts receivable, another item which is likely to be larger than in the domestic trade, because of the longer terms of credit common to foreign trade.

Ample resources, therefore, constitute a necessary precedent condition to any attempt to establish a direct system for the individual sale of a producer's goods. But this is by no means the only condition. It is often, but erroneously, assumed that a business unit with sufficient resources can afford to follow almost any

plan of distribution, whether or not it is in accord with good business policy. In the long run the expenses of doing business by any organization must be covered by the proceeds of the sale of the products of that organization, and if the expenses due to the selection of wrong methods be too high, such an organization must ultimately fail. This seems so obvious that one hesitates to set it forth in this bold manner and still it is overlooked by those who explain almost any business policy on the grounds that the business is rich enough to afford it.

One of the conditions which may reduce the cost of foreign sales is a large volume of business with a particular market, for under this condition the cost of selling and physical distribution per unit of product may be reduced to an amount comparable to that incurred by the export house. Large sales to the world at large is not sufficient, but sales in one region must be large enough to utilize constantly the sales force and the organization for physical distribution. Few producers enjoy an equally large market in all parts of the world, and hence even those concerns which are most commonly cited as employing the direct method do use the indirect method for reaching some parts of the world.

As to the nature of the product there is a vast difference, from the marketing point of view, between adding machines, typewriters, phonographs, patented drug products, and automobiles, on the one hand, and wheat, cotton, lumber, wool, plain cotton textiles, on the other. The former, for lack of a better term, may be called specialties, and they are uppermost in the minds of most writers upon the business of foreign trade. Goods of the latter type, the staples, still constitute the larger part of the objects of international commerce. Active demand-creation, or selling, is very important with the first group, while it is of relatively little importance with the latter. This is true for two reasons. First, many products of the specialty group are demanded only when they have been called to the attention of the prospective buyers. The demand is latent, not active. This is especially true when the product is new to the particular market. Second, even though the products as a class be familiar to the prospective

buyers, there is usually a difference between the products of different producers. Even though there may be a demand for phonographs in any market, it may still be necessary for any manufacturer to create a demand for his particular kind of machine as opposed to the products of other manufacturers. This is quite possible with this product and with most products of the specialty group. It is not possible, nor is it necessary, with products of the staple group. Units of these goods, while they may differ from one another, are classified by grades, that is, according to size, quality, or weight; and these distinctions do not correspond to the different producers who turn them out. Thus "middling" cotton differs from other grades, but this grade is produced by thousands of growers and each grower may produce this and other grades. Specialties are commonly distinguishable according to their producers; staples are not. Therefore, the producer of a specialty finds it profitable to engage in demand-creation not only for the product in general but also for his own brand of the product; producers of the staples have no incentive for the latter or competitive demand-creation. Now this distinction bears on the question of direct marketing. Specialized middlemen are usually unequalled in the performance of most of the marketing functions, but they are ineffective in creating a demand for the product of a particular manufacturer. They are interested in total sales and are often indifferent or possibly even hostile to the emphasis on a particular brand or trade name. Where this factor is important, therefore, manufacturers are often led, despite the greater economy of the other method, to establish their own sales organizations. The more effective performance of the demand-creation function is probably the chief motive in establishing direct marketing. The increasingly important part in American export trade played by goods to which this method is adapted goes far to explain the recent great increase in direct marketing.

Some manufacturers who desire to look after the demand-creation function themselves but who recognize the advantages of the export houses in the performance of the other functions

find a satisfactory compromise in providing for their own advertising and sending their salesmen into the field to work in cooperation with the export house. Orders taken are filled through the commission house, which looks after the transportation, engaging shipping space, delivering the goods to the customer, paying the manufacturer's bill promptly, and extending credit to the customer, engaging marine insurance, and seeing that consular regulations are observed. This is similar to the plan used by some companies in the domestic market where the manufacturer's salesmen take orders which are filled through jobbers.

The need for direct selling effort is greater when the product is so complicated that it requires specially trained men to handle it. Further, it usually happens that if the product is so complicated that its selling requires technically trained salesmen, there will also be a need for service after sales in making repairs and adjustments. Obviously, the independent general exporters cannot be depended upon for such services. This seems to have been one factor which has led to the direct marketing of agricultural implements and other kinds of machinery.

Some goods require special facilities for transportation and storage. Tank vessels, special storage facilities, and tank wagons are required for the efficient handling of petroleum, and refrigerator vessels are necessary for handling tropical fruits. In these two lines and others the nature of the product and the conditions of production are such that one could not safely rely upon independent middlemen for the supplying of these facilities. The direct marketing systems of the Standard Oil Company and the United Fruit Company illustrate the steps taken to meet the requirements of their respective trades.

The nature of the market also influences the marketing system employed. If the market is close at hand, there is a greater possibility of using the direct system. Thus Canada, Mexico, and the West Indies are often treated by American manufacturers much as are the more distant parts of the United States itself, while South America, the Far East and other over-seas markets are left to the independent middlemen.

Again, the development of a market commercially and politically influences the decision. The manufacturer who elects to do his own marketing in the commercially developed countries may leave more backward regions to the export houses. On this basis and that of location, a classification of Latin-America as a market for manufacturers of the United States was made in 1910.[1] The Latin-American countries were placed in three groups as follows: Group I, Cuba and Mexico; Group II, Haiti and San Domingo, Central America, Venezuela and Colombia; Group III, the remainder of South America. Group I, being more accessible to the United States and being fairly well equipped with commercial machinery (largely foreign), was held to be a suitable field for direct marketing; Group II, because of the lack of these facilities, was held to be the almost exclusive field of the export houses; while Group III was designated as debatable ground. Though the conditions in these countries have changed somewhat since 1910, the above distinctions emphasize the importance of the nature of the market in determining upon a sales program.

The conclusion to be drawn from this analysis is that it is impossible to say that either the direct or the indirect method is generally superior to the other. The indirect method ordinarily has the advantage of economy. The small manufacturer is restricted to this method almost regardless of other considerations. But the large manufacturer may find that special considerations concerning the creation of demand, after-sales service, and requirements of transportation and storage may make the direct system preferable. Even such a producer, however, is likely to be influenced by the nature of the market and its distance from his producing center.

It may seem that the obstacle to direct marketing found in the small size of some of the purchasing units and their small volume of foreign trade, could be overcome by permitting the producers of competing products to combine for the purpose of foreign selling. The Webb Law was passed to exempt such combinations from the prohibitions of the antitrust laws in this country. But

[1] W. C. Downs, *Quarterly Journal of Economics*, 26: 121.

American manufacturers have not taken advantage of this opportunity to the extent anticipated. This is no doubt due to a number of considerations, but one at least has been the reluctance of manufacturers to join in a common enterprise for the advancement of their foreign interests with other manufacturers with whom they are in keen competition in the domestic field. Domestic and foreign sales policies are so interrelated that it does not seem possible to maintain competition in the one field and coöperation in the other. This is especially true because the foreign sales of most American manufacturers forms only a small part of their total sales. The situation is quite the opposite of that which has existed in German foreign trade and which was often pointed to by advocates of coöperation in foreign trade. There coöperation and combination in the domestic trade was encouraged rather than repressed, and coöperation in the foreign market was, therefore, a natural extension of the relations existing at home. Further, the foreign market was relatively more important to the individual German manufacturer than it is to the American. Concessions of individual freedom of action were made, therefore, which would not be considered worth while in this country.

CHAPTER X

PRINCIPLES OF OCEAN TRANSPORTATION

The construction of one of the largest merchant marines in the world in a period of two years stands out as one of the greatest war-time achievements of the United States. Before the war about ten per cent of our over-seas trade was carried in American bottoms. It was a constant source of humiliation that one could travel over the ocean highways for weeks at a time and never see the American flag in the crowded harbors of the world. This was especially galling because in our early history we held a very respectable place in the maritime affairs of the world.

History of American Shipping

In our colonial days the sailing vessels of New England extended their activities into all parts of the world, and much of the capital wealth, which was later to be diverted into New England manufacturing, was amassed in this industry and the trading which accompanied it. There were sound economic reasons for this shipping development. The English had long been a seafaring people, and those who ventured forth to a new continent were of the hardy strain required for this dangerous pursuit. Many of these early colonists were, moreover, experienced in the business of building and operating vessels. England's supply of timber for shipbuilding was limited at the time, and these supplies existed in abundance in New England. Not less significant was the fact that the barren lands of New England did not afford the inducement for agriculture to be found in the middle and southern colonies. It was, therefore, partly due to their disadvantages in other lines that the northern colonists turned to building ships both for sale to England and for their own use in commerce.

New England's commerce grew apace with its shipping. This

was almost inevitable, for in those days shipowner and merchant were usually one and the same person. To enter into shipping was to become a merchant. It was a common experience for a trader to set forth with a vessel from a New England port, purchase a cargo of goods at a southern port or in the West Indies, and dispose of this cargo in some foreign port, using the proceeds to buy another lot of goods, which were again sold, and so on. Perhaps at the end of two or three years the vessel itself would be sold at a foreign port where vessels brought a higher price than in New England. Thus the businesses of building vessels, operating them, and trading were closely connected. To-day most exporters and importers have no interest in the ships which they use, and indeed it is quite possible for a nation to be extensively engaged in foreign trade without owning a great number of vessels. In colonial days, however, and to a less degree throughout our early national history, commercial development and shipping development were highly interdependent and a trading country was necessarily a shipping country.

With the development of the country, other employments for the capital and enterprise of New England appeared, first in the form of manufacturing in New England itself, and second in the building of railroads and in otherwise developing the West. The latter opportunity for investment was particularly attractive immediately after the Civil War period. It thus came just at the time that our merchant marine was demoralized by the naval operations of the war. The confederate raiders, no doubt, were instrumental in bringing about the decline of the American merchant marine, but they did not constitute a major cause. A change had also come in the art of shipbuilding, which destroyed the advantage which New England held in ship materials. This was the change from wooden vessels to iron, and later to steel. In the construction of the new type of vessels England had a considerable advantage over the United States down to the latter part of the last century. This factor need not have been important, for English and other foreign yards were quite willing to build vessels for American purchasers on

terms as favorable as those granted to foreign operators. But the United States, in an effort to protect the American shipbuilding industry, prohibited American registration to foreign-built vessels. So the decline of American shipbuilding contributed to the decline in American shipping. The decline of the American merchant marine as a result of these factors can be seen in the proportion of American foreign commerce carried in American vessels. About 90 per cent of American commerce was so transported from 1800 to 1830. By 1850 the proportion had declined to 72 per cent, in 1860 it was 66 per cent, in 1870, 35 per cent, in 1880, 17 per cent, and by 1900 it had declined to 9 per cent. This condition continued practically unchanged to the outbreak of the European war. As a result of the ship construction of the war period, the American merchant marine transported 43 per cent of American exports and imports in 1920.

Prospects of the American Merchant Marine

The merchant marine which we now possess stands on an entirely different plane from that which we had during our early history. It was built not in response to economic needs but as a war-time expedient. For many years Americans have bemoaned the state of our shipping, but the significant fact is that these same Americans were and still are unwilling to invest an adequate amount of their own capital in ships. In consideration of the rate of return on shipping, it is not surprising that investors should prefer the securities of American railroads and industries. Generally speaking, those countries which have large and permanent merchant marines are those which have few opportunities for investment in their own internal development in comparison to the capital and enterprise available, in other words, countries which have a small demand for capital and enterprise relative to the supply of them. This relation may be due to a paucity of natural resources, as is perhaps the case with Japan, Greece, the Netherlands, and the Scandinavian countries. Or it may be due to a very large supply of capital and a large number of business enterprisers, as is the case

with Great Britain. Both conditions lead to the same result: that such a country turns to ocean shipping because this industry is profitable when compared with the other possibilities. But standards of profits, as of wages and interest, differ from country to country, and returns which are attractive in the Netherlands or even in Great Britain may well be insufficient to attract the factors of production in the United States. This is in fact the situation in ocean shipping. Where this condition prevails, it indicates that we are at a *comparative* disadvantage as regards the industry in question. This comparative disadvantage is due to the fact, not that we cannot operate vessels as well as those other countries can, but rather that there are many other things which we can do much better. Comparing our present situation with that of half a century ago, we may be led to think that our internal development has proceeded so far that we are now in a class with the older European countries. But the rates of interest, profits, and wages are the test; and on this score American capitalists, laborers, and enterprisers indicate by their preference for domestic industries, that our supply of these factors in relation to the demand for them is not sufficient to induce us to take to the sea.

If our capital and population continues to accumulate at home, the rates of interest and wages may decline to such levels as will make seafaring an attractive industry. Any large merchant marine built up before that time must be supported by more or less artificial means. When a country in which the rates of interest, profits, and wages are high enters into competition in ocean shipping with countries in which the factors of production are accustomed to taking lower rates of return, it is likely to suffer a considerable disadvantage, unless there are some special factors giving it a degree of efficiency high enough to offset the difference in return demanded. It is questionable whether Americans at present enjoy these advantages in efficiency in this particular industry over such maritime peoples as the Scandinavian, the Dutch, and the English. If this statement of the case is correct, it would be poor economy to divert even part

of our capital, labor, and managerial ability from production, in which we clearly do have an exceptional opportunity, to ocean shipping, in which we are at least no more efficient than others.

It appears, therefore, that at present the economic conditions are not ripe for the establishment of a great merchant marine upon a basis of individual initiative and investment. In making this statement we have in mind not the fast passenger lines, but rather a great fleet of cargo carriers—the type of vessels which, in fact, carry the great bulk of international trade. If such a fleet as we have built up under the war stimulus is to be maintained under the American flag, it must be done by some kind of governmental encouragement. This may take the form of continued ownership of the vessels by the national government, perhaps leasing the vessels to private operators at low rates, payment of a subsidy to American shipping companies, protective taxation of foreign ships in our trade, or some similar expedient. The continued operation of vessels by the government would constitute a serious obstacle to the development of competing private companies, and, in so far as the government rates were low enough to yield any benefit to American shippers, there would almost certainly be a deficit to be met from the government treasury. Our private companies, not having access to the Treasury, would hardly look kindly upon such a plan. The history of shipping subsidies in other countries is not such as to encourage our adoption of such a policy. High taxes on foreign shipping would no doubt lead to reciprocal discrimination against American ships abroad.

The fundamental difficulty is that American investors and business men have other and much more attractive fields for their capital than ship operation. When such a situation arises in any domestic industry, we have been accustomed to adopt the simple expedient of a protective tariff. But the tariff can at best only preserve the home market, while ships must, in the nature of the case, sell much of their services to foreigners. In this world shipping market (one of the most highly competitive markets known) the effective American method of protection proves of no avail.

Further, manufacturing, agriculture, and mining enjoy a natural protection as regards the home market in the advantage of being near to the market. The cost of transportation from the foreign producing centers to our markets acts much as a protective duty against the foreigner and in favor of the home producer. No such protection exists for home ships, for it is as easy for a foreign vessel to sail into an American port for cargo as it is for an American vessel.

One more significant fact should be noted in connection with this problem; namely, that a large part of the world's shipping is operated, not by owners, but by time-charterers. For years before the late war and since, ships of all nationalities have been offered for charter in the freight market of the world on equal terms to all bidders. The fact that American operators have not chartered more vessels on this plan is *prima facie* evidence that ship operation is not an industry which appeals to American enterprise under present conditions.

The question of an American merchant marine has been discussed here from the point of view of a wise use of American labor and capital, judged purely by economic standards. It is true that there are other aspects of the question, for example, the consideration of military preparedness. On this side of the question no opinion is expressed. We should, however, insist that the two aspects of the problem should not be confused. The advantage, if such there be, of an American merchant marine as an adjunct of the navy should be set against its cost on the economic side. The one consideration opposes rather than supports the other.

Tramps and Liners

The merchant marine of any country is made up of carriers of widely varying types, both from the point of view of construction and of ownership. Because of their immense size and speed and the recent national rivalry in their construction, the liners attract the attention of most people who think at all about ocean transportation. The ocean liner, however, holds much the same position in overseas transportation that the fast passenger and

express trains hold in railroad transportation. As every one knows, the railway freight service is far more important in earnings and capital invested, and as a factor in the modern industrial organization. Just so, the tramp vessels are really of more importance as an economic factor than the liners.

The tramp is a freight-carrying vessel which has no regular route or schedule of sailings. It is first in one trade and then in another, always seeking those ports where there is a demand at the moment for shipping space. It thus has certain advantages over its more aristocratic sister. It is not obliged to sail over any route unless freight is offered for that voyage at a favorable rate. The liner often sails with only a partly complete cargo. The tramp does not have to wait in port until a definite sailing date. It loads its cargo as quickly as possible and departs, always in search of the most advantageous employment. If the general freight market is depressed it may tie up in port to wait for more favorable conditions, thereby stopping a large part of its operating expenses.

These advantages are especially marked in ocean transportation because of the seasonal variations in the demand for shipping in each route. At one season of the year there will be an active demand for ships to carry cotton from our Gulf ports to Europe. As this demand fails, some other great freight movement begins. It may be grain from the River Plate or from India, nitrates from Chile, or sugar from Cuba. The tramps are able to shift their employments with these shifting demands. Thus the world's supply of tramp vessels constitutes a pool from which each trade can draw tonnage as it may need it. The liners are bound to particular routes and hence are much less adapted to handling these great seasonal movements of cargo.

In addition to these advantages growing out of the nature of the business of the tramp, it is able to attain lower costs because of its type of construction. There are two ideals to be attained in all forms of transportation—speed and economy. The liner approaches the former ideal, the tramp approaches the latter. Speed is attained by the liner by the type of construction of the

hull and the power of its engines. The liner is built on long, narrow lines, a type of construction which conduces to speed but sacrifices cargo-carrying space. In order to attain a high speed it is necessary to install powerful engines, and even then the speed does not increase in direct ratio to the power. A great increase in weight and power of engines and in the space devoted to them is required to get an increase of speed from twelve knots to fifteen knots an hour. Not only the space, weight, and expense of the engines increase, but the amount of bunker coal, space for its storage, and crew for its handling are greater. Some liners use as much coal in a day as would suffice to propel a slower tramp vessel across the Atlantic and back again. The most effective types of vessels for the two services are, therefore, different. A qualification should be made to the effect that some lines exist primarily for the purpose of handling freight. Such lines might use a type of vessel similar to the tramps. Ordinarily, however, the requirements of the two services as to types of vessels are quite different.

On account of the less rigid program of the tramp and the lower operating costs which arise from its type of construction, and, on the other hand, of the greater speed and regularity of service of the liner, there is a rather clear division of the field between these two types of carriers. It is estimated that about sixty per cent of the world's commerce is carried in tramps, They largely handle the great movements of grain, cotton, coal, lumber, ores, nitrates, and many products of a more highly fabricated nature. On the other hand, manufactured products of higher specific value, perishable products, and small lots of goods of almost all classes go by liners. The difference is somewhat the same as exists in railroad traffic between the products handled by express and fast freight, on the one hand, and those handled by slow freight, on the other.

Sometimes this dividing line breaks down in practice. A liner scheduled to sail from New York for Liverpool on a specified date may find that very little high class freight is offering. At the last practical moment it may decide to fill its available space

with grain, which, at least, serves the purpose of ballast. Under these conditions grain may be carried by liner at as low a rate as would be given by slow tramps. Or, if the space available is nearly taken up with relatively light, bulky products, such as furniture, it may decide to take on a certain amount of pig iron or steel rails to give it the proper weight. On the other hand, if liner rates become unusually high, a certain number of rather fast tramps may be brought together to operate on regular schedule and thus compete for this natural liner traffic. Under similar conditions the line may hire a tramp vessel to supplement its own fleet. If traffic is scarce the line may send some of its slower vessels to rove over the seas in search of traffic until business on the regular route improves. In other words, this liner becomes, for the time being, a tramp. These instances, however, are exceptions to the rule that ordinarily we have two classes of carriers, each of which has a more or less strictly defined field of activity.

As the traffic over any trade route increases and becomes more varied, there is a tendency for the proportion carried by liners to increase. In fact, a century ago there were scarcely any routes that would justify a regular service. However, on account of the seasonal character of much of the traffic and because of the fact that hardly any trade route has an equal volume of traffic in both directions, the elimination of the tramp is highly improbable A British committee on investigation of *post bellum* shipping problems was of the opinion that England's commercial supremacy rested primarily on its fleet of tramps.

Another class of vessels which has become of increasing importance in recent years is that of specialized carriers such as oil tankers and refrigerator vessels. These vessels are often owned by the companies which are shipping the products for which they are adapted. For example, the Standard Oil companies have a fleet of tankers, and the United Fruit Company has a fleet of refrigerator vessels operating in the Caribbean region.

There has been a tendency on the part of some other corporations to establish fleets of their own, not because the nature of their products is so peculiar as to require it, but to insure a regular

service that would not be maintained by independent shipping companies. The United States Steel Corporation, through its exporting subsidiary, is one example, and the merchandising institution of W. R. Grace and Company is another. Aside from a comparatively few instances of this kind, however, the shipping facilities of the world are independently owned, and, for the most part, are available to all shippers on equal terms.

Ship Chartering

Tramp vessels are employed by shippers through chartering. The chartering contract may be drawn up on any one of several bases. That most commonly employed between the shipper and the carrier is a trip charter, according to which a specified rate is paid for carrying a shipload of specified goods over a certain voyage. The significant facts are that tramp vessels are for hire and that, although the demand for shipping is often for certain types of vessels, there is, nevertheless, sufficient interchangeability in the vessels and their uses to provide the ground for keen and free competition.

Another charter relationship exists between the owner of a vessel and its operator. The practice of chartering vessels for operation is common. In such a contract the operator pays for the ship on a basis of ship tonnage and time. The operator supplies the fuel and pays all other expenses of operation, except that the owner provides and pays for the crew and their provisioning. The contract is known as a "time" charter. The "time" charter is used between owner and operator; the trip charter is between operator (whether he be owner or not) and the shipper. Under normal conditions it is often as profitable for a ship operator to charter vessels on the time basis and then solicit freight on a trip basis, as it is to actually own the vessel. This fact materially weakens the position of those who contend that foreign shipowners manipulate their tonnage in a manner unfavorable to American foreign trade interests. Any ship operator can charter a vessel on this basis and operate it at any rate and in any trade he may choose.

There probably is no market for commodities or services, with the possible exception of such organized exchanges as exist in the grain and cotton trades, which is more highly competitive than is the market for the services of tramp vessels. The roadbed on which these carriers operate is free to all; it is kept clear of wrecks and is charted and marked by the governments of the world with no expense to the carriers. Every port of the world is more than willing to receive vessels, and many of them have provided landing and loading facilities which are available for use at a price which is not expected to cover the interest upon the capital invested. All these advantages make it possible for vessels to shift their operation from one region to another with the greatest freedom. Furthermore, tramp vessels, for the most part, are available for carrying many different kinds of goods.

The supply of vessels in the whole world is, therefore, liquid. A shortage of shipping in the Pacific will be met in a few weeks by vessels flocking to that region from all parts of the world. If there is a shortage of vessels for carrying cotton, vessels will be attracted from the lumber or grain trades. Ocean freight rates are extremely sensitive to all factors affecting the supply of and demand for shipping space. The knowledge of the rate situation at all ports is quickly disseminated and is published in the shipping journals, much as are the prices of grain and cotton in the trade journals devoted to those commodities. The competition is intensified by the operations of "brokers" who deal in ships or shipping space. These may be brokers in the strict sense of the term, *i. e.*, acting as agents for ship operators or shippers, or they may be independent middlemen buying and selling shipping services on their own account. In either event they are constantly on the watch for rates that seem to be higher or lower than the conditions of demand and supply warrant.

This whole system of business relationships for dealing in freight space focuses in the charter market of London. The center of this market is the "Baltic," an organization comparable to our stock or produce exchanges. The name is unfortunate as the exchange is not especially concerned with the trade of any

specific region. The rates fixed by open bidding in this organized market have a marked influence upon the world level of rates although the larger number of shipping transactions are made outside the exchange.

While there is a world market for shipping space, there are, nevertheless, occasions when the freight rates at a single port may mount to very high levels. Suppose, for example, that there is an unusually large supply of cotton at Galveston, that this offering of freight has not been anticipated by shipping men, and, therefore, there is only a small available supply of vessels at Galveston or in that region, and, lastly, that the shippers of the cotton are for some reason anxious to have it dispatched for Liverpool at once. Under these conditions the cotton dealers will bid for the service of the few ships in port until, on account of the high rates brought about by this competition, only those shippers who are most anxious to obtain immediate services will remain in the market. They will get the ships, but at a very high charter rate. This situation can last, however, only as long as it takes vessels to get to Galveston from other ports, assuming, of course, that there is not a world shortage of shipping. If, on the other hand, many ships are in a port discharging cargoes, they will all be seeking outbound freight, and the competition of ships for cargoes may bring rates to a very low level.

These situations do not occur as often as might be expected, for normally the conditions giving rise to them would be anticipated by the brokers and ship agents who are in constant touch with all parts of the shipping market. Through these middlemen, ships are ordinarily chartered at a sufficient time in advance to insure their presence at the port when the goods are ready for shipment. Likewise, the agents of a vessel en route from the River Plate to New York will be searching among American shippers for a profitable employment for the vessel as soon as it is unloaded. By use of the wireless telegraph it is now possible to direct a vessel to a certain port while it is still on the high seas. This tends to facilitate the adjustment of the supply of vessels to the demand for them.

Ocean Freight Rates

It appears that the market for the services of tramp vessels is a highly competitive one. The rates for these services are, therefore, controlled by the free operation of the forces of supply and demand. But there are certain peculiarities in the operation of these forces in respect to the services of ocean carriers which should be noted. The succeeding discussion refers particularly to the rates for tramp vessels, but most of what will be said also applies to liners, although there are additional factors of a more arbitrary nature which affect liner rates.

There are three classes of goods and services as regards the relation of supply of and demand for them. First, both the supply and the demand may be sensitive to changes in the price of the goods. This tends to keep the price steady. Second, the demand may be very steady, but the supply subject to fluctuation on account of factors other than price. Under these circumstances the price is likely to fluctuate widely. This condition is exemplified by the price of wheat. Third, the supply may be relatively stable regardless of the price offered, while the demand fluctuates widely. In this case as in the second, the price will fluctuate. Shipping services fall in this class. The demand fluctuates with every change in general business conditions the world over. The supply, on the other hand, changes but little because the supply of shipping services depends primarily upon the supply of vessels; and the supply of vessels is not easily changed. Suppose the demand increases because of prosperous business conditions. The price of shipping services starts to rise. Now, with some goods and services we should expect that at this point the supply would also increase in response to the higher price and thus prevent the price from going still higher, but in this case the supply of services can only be increased by increasing the supply of ships, and to build ships takes time. Shipbuilding also takes a large amount of capital; and if investors think that the existing high rates are merely the result of a temporary boom, they may refuse to invest their capital at all. As a result prices may continue to

rise to very high levels. On the other hand, when the demand declines, rates will fall, but the supply does not promptly decline in response to the low price, for the existing supply of ships is not affected by the price decline. True, if the rates fall low enough, ships may remain in port, but rates must be very low indeed to force an adjustment of supply to the new demand in this way.

What is the lower limit below which the ships will not in any circumstances carry freight? This lower limit is fixed by the cost of the service, but this cost in itself is not as definite as it may appear at first sight. Is this cost of service to include the prevailing rate of return upon the capital invested as well as the ordinary depreciation and insurance upon the vessel, or does the term simply cover the costs of operation, *i. e.*, those costs which will be incurred if the vessel is operated and which would be avoided by tying it up? Further, if the term means cost of operation, does it include all costs of operation or merely those costs which are incurred by accepting and carrying a certain shipment of goods and which would not be incurred if the vessel sailed without cargo?

These questions suggest that we have three meanings for cost of service: (1) all costs including depreciation, interest charges, and other "fixed" expenses; (2) only those costs which are incident to operating the vessel but which would cease if the vessel were not operated (it should be noted that these do not cover interest on capital and other "fixed" expenses, for these go on whether the vessel is operated or not); (3) costs incident to the carrying of a specific lot of goods. This interpretation is still more restricted than the second, for most costs of operation are incurred if the vessel is operated regardless of the amount or character of the cargo carried.

Cost of service in each of the three senses mentioned acts as the minimum for rates in different cases. The world level of rates over a long period of time (long enough for an appreciable part of the world's shipping to wear out) must be high enough to cover all costs, including depreciation and the normal return

upon capital; at least investors must believe that rates will be high enough to cover these items. If the prospects are that rates will be lower than this, new ships will not be built to replace the old as they wear out, and the supply of ships will gradually decline until rates are forced up. However, this wearing out process takes time, and within that time there is no guarantee in the economic forces at work that the items mentioned will be covered by the prevailing rates.

Although it is true that supply does not respond immediately to an increased demand, it does respond more easily in this direction than in the opposite. That is to say, it is easier to increase the supply of ships when the demand is brisk than to diminish the supply when the demand is slack. Therefore, a short period of high rates such as were occasioned by the demands of the British government during the Boer War, and such as existed in a much more marked degree during and after the late war, may be sufficient to bring into existence a world merchant fleet that is far in excess of normal requirements. This excessive supply of ships may keep rates at an unprofitable level for several years.

This condition is accentuated by the fact that there seems to be a tendency among shipping people, as among many others, to take an optimistic view,—centering their attention upon the profitable years, in which, it is true, very high returns are made, and disposing of the unprofitable years as unusual and not likely to continue. Further, ship construction often continues even during periods in which rates are too low to be profitable for the existing ships. This is partly due to the fact that shipbuilders have large amounts of fixed capital which they are loath to have lying idle. In times of shipping depression, therefore, they offer to build vessels at low prices and to extend favorable terms to prospective purchasers.

There are two results of these factors: first, the world level of ocean freight rates fluctuates widely from year to year; and, second, over a long period of time there is a tendency for ocean freight rates to strike an average so low that for shipowners as

a class the returns on capital invested are low. According to some men who are intimately acquainted with the business, the average returns are lower than the prevailing rates in much more conservative industries. It is difficult to substantiate this latter conclusion although the earnings of some well-established lines seem to support it.[1] The fluctuations in the level of rates from year to year are apparent even when we consider an index number of charter freight rates, and, of course, they would be much more marked if we considered one specific type of vessel or the vessels in any specific trade. There are given below index numbers showing the fluctuations in the annual averages of ocean charter rates:

TABLE 16. INDEX NUMBERS OF OCEAN CHARTER RATES
AVERAGE 1890–1899 = 100 [2]

1870	195	1911	82
1875	260	1912	111
1880	205	1913	100
1885	130	1914	105
1890	118	1915	323
1895	87	1916	634
1900	110	1917	1841
1905	83	1918	2492
1910	69	1919	561
		1920	330

We have now seen that there are forces which tend to keep the world level of ocean freight rates over a long period high enough to cover, in addition to costs of operation, a reasonable return upon invested capital, but that, on the other hand, there are other considerations which tend to make the rates, even in the long run, a little lower than this. Further, the level of rates in any one year may fall far below these "normal" rates, so low in fact that they little more than cover the costs of operation. Such extremely low rates may be caused by the fact that a vessel owner would rather operate and accept one-half of one per cent upon his capital investment than cease operation and make

[1] See, for example, data given by E. S. Gregg, *Quarterly Journal of Economics*, August, 1921.

[2] *Ibid.*

no return at all. If competition for freight becomes very keen, vessel owners, even all vessel owners, may accept rates as low as this, and these low rates may continue for some time.

Will specific shipowners ever accept less than this? Yes, under certain circumstances. In fact, a considerable part of the world's commerce is carried for even less than the total cost of operation. Suppose a vessel is at Baltimore and, having discharged its cargo, it finds that very little freight is offering from that port. But there is a demand for vessels at Galveston for moving cotton. The ship's agents charter it for that trade. It must sail to Galveston, and in doing so most of the cost of operating a loaded vessel must be incurred. Suppose at this juncture a cargo of coal is offered for Galveston. What is the lowest rate which the ship will accept? If necessary to get the business, it will accept a rate which is only slightly in excess of the loading and unloading expenses and the cost of the extra fuel which will be required to operate the vessel loaded as compared with the cost of operating it in ballast. Very low rates may be made in such cases. This extreme situation is approached in every port which receives more freight than it sends out. Thus the rates prevailing from certain European ports to the United States are lower than rates in the opposite direction, for the eastbound trans-Atlantic traffic is more bulky than is the westbound traffic. Another example of the operation of this principle is in the relatively low rates on British coal exports. Coal is about the only bulky product leaving European ports for other parts of the world. Therefore, a vessel having brought cotton to England and proceeding from there to Argentina for wheat, considers a load of coal for Argentina as ballast and, therefore, gives it a very low rate. However this freight is much better than nothing and, consequently, vessels are always glad to carry grain to England, because they know that they will not have to leave empty. Some people have argued recently that coal exports from the United States would be advantageous from the shipping point of view. It should be noted, however, that our situation is the reverse of that of England, and that coal from the United States

would have to attract vessels here from other trades for the specific purpose of carrying the coal.

This factor of cargo for the "back haul" must be given due weight in every estimate of the rates which will probably prevail over any route. For example, it cannot safely be disregarded in estimating probable rates through the proposed St. Lawrence waterway. The nature of the traffic which would pass through this waterway is so much a matter of conjecture that no judgment is ventured here. But it can safely be said that, if the traffic to Duluth and other Northwest ports is not sufficient to balance the traffic in outbound grain, the inbound rates must be relatively high to attract ocean vessels to these ports. And it must be remembered that in this connection traffic is primarily a matter of bulk rather than of value.

The principle applies with equal, if not greater, force to liners, because liners are obliged to sail at scheduled dates. A large part of our grain exports, especially those passing through the port of New York, is carried in liners which operate, of course, not for this purpose, but primarily for carrying passengers, mail, package freight, and express. Since it is usually impossible to fill a large liner with this high-class cargo, the liner is often willing to take on grain to complete its cargo at a very low rate.

CHAPTER XI

OCEAN STEAMSHIP LINES

While it is true that the bulk of the world's trade is carried in tramp vessels the majority of exporters are sending goods abroad in such comparatively small lots that they are more vitally concerned with the liner service. The interest of the exporters of the United States in liner service is increasing, because our exports are becoming more diversified. A line is a number of vessels under a single control, operating regularly on a stated schedule between specified ports. The most widely known lines are those which offer high-class passenger service, but there are also lines which devote their attention almost exclusively to freight. Between these extremes there are many varieties of regular lines.

Lines Compared to Railroads

In the liner's service and rates we find conditions somewhat comparable to those existing in railroad traffic. While the tramp, because it is operated only on special contract, is classed as a private carrier, the liner, like the railroad, is a public carrier. It operates on a regular schedule and holds itself out to carry goods for anyone up to its capacity, upon the payment of specified rates and upon compliance with certain conditions which are the same for all shippers. True, deviations are often made from these published terms (much more often than in the case of railroads) but, presumably, the new conditions, as the old, apply to all alike. This characteristic has an important bearing on the problem of government regulation. Common carriers are required (under the common law) to treat all shippers impartially, and the right of the legislature to fix maximum rates and otherwise regulate the common carrier in the interests of the public is well established.

This is not true of private carriers. As a result of this distinction the present United States Shipping Act, which provides for the regulation of rates and practices of ocean carriers, specifically exempts from its provisions all vessels commonly called ocean tramps.

Another similarity to the railroad is found in the regular schedule and regular route. These give the line an interest in the prosperity and development of the ports and regions served which is lacking with the tramps. This interest has an effect upon rates charged. Although the lines serving two regions may each be free of competition within its own region, their rates cannot be unaffected, one by the other, if the products of regions A and B sell in the same market. The line serving A cannot charge rates which are unduly above those charged by the line serving B, for if it did the sellers in A would be forced out of business by the competition of the sellers of B, and the A line would lose traffic. This is a case of regional competition. It is an important factor in making railroad rates and ocean liner rates, but it does not so clearly operate in the case of tramps, for the tramp has no permanent interest in any particular trade.

Conditions Favorable to Liner Service

There seems to be a normal tendency toward the establishment of regular liner services. The earliest commerce of a region is usually handled by tramp freighters; as the volume of trade grows a combined passenger and freight service may be established operating on a regular schedule; if the trade develops still further there may come a more or less distinct separation between passenger lines and freight lines.

Certain conditions are favorable to the establishment of regular lines by private enterprise: (1) There must be a steady supply of goods to be carried. Our cotton crop, although its volume is great enough to justify a regular service, would not in itself attract such service because of its seasonal nature. Where other products supplement the one seasonal product, as the varied products of our northern ports supplement the grain crop, the

line may be successful. (2) There must be goods of a high class, that is, traffic which will bear a fairly high rate. Even if the other conditions were present a line would hardly be established for the primary purpose of carrying coal. (3) There should be a balance between the traffic moving in opposite directions over the selected route. This is one of the difficulties of operating regular lines between North and South America. The volume of goods brought into the United States from South America is much larger than that going in the opposite direction, and would probably continue to be larger even if our exports to South America increased very greatly, because the goods which we sell to South America are of higher specific value than those imported from South America, *i. e.*, our imports from this region are of greater bulk, for the same value, than our exports. (4) The rates should not be unduly depressed by tramp vessels seeking return cargoes.

To the extent that private commercial motives control, line service will be established with a region only when the above conditions are sufficiently favorable to promise a remunerative trade. But if a government intervenes, lines may be established in advance of the fulfillment of these conditions either by subsidy or by outright government operation. In embarking upon such a program a government may be proceeding on the theory that the very existence of a regular line service will hasten the development of trade to such a point that the line will become profitable. That is, the government aid may be in the nature of temporary assistance to an infant industry. Or, again, the purpose may frankly be to advance the interest of its own traders as against their competitors in other countries. Government stimulus to lines should be undertaken very cautiously. There is not, on economic grounds, as much justification for it as there is for government aid or enterprise in opening a new part of its domestic domain by subsidizing or building railroads, for in the case of ocean transportation there is always a supply of tramp vessels available for any region which can use them. Further, the building of a railroad may involve so much risk that private capitalists

will refuse to undertake it, because when a railroad is once built, the capital has been irrevocably invested in the project. But a line of vessels can be assembled from other trade routes and if the project proves to be unprofitable they can be returned to their old employments. On the whole, it appears that the establishment and operation of steamship lines is not a business in which government enterprise is needed—at least if we view these lines as purely economic agencies.

Agreements Between Lines

In the preceding chapter there were noted certain characteristics of ocean shipping which make for very keen and often disastrous competition between carriers. To avoid the results of such competition attempts have been made to maintain rates by agreements among ship operators. Such attempts have universally failed when applied to tramp vessels, but agreements are commonly maintained among lines. The term "conference" is used to describe an association of the lines of a given trade in such an agreement. Conditions are more favorable for such agreements in the line services than among tramp vessels. In the first place, the capital requirements for building or buying a line of vessels are much greater than for individual tramp vessels, and this fact alone deters competitors from entering the field against a combination. So we find the conferences are more successful among the high class passenger lines than among the freight lines. Second, the number of owners are fewer and hence an agreement is more easily made. Third, the incentive for maintaining rates in a region is greater for the lines. The tramp, having cut rates and demoralized the market of a region, sails away to another trade—to return only when rates are again high. But a line which demoralizes the freight market in a similar way must remain to suffer the consequences. There is, therefore, a very strong incentive for lines to enter an agreement and to live up to its terms. Even if tramp vessels were formed into a conference, the temptation to violate the agreement at the first period of freight shortage would be much greater than for lines.

The cargo of the liner is made up of many individual shipments; hence, if all the lines maintain rates they will all get some traffic. Among tramp vessels the whole ship is commonly chartered as a unit. Therefore, if there are ten freight carriers in port at a time when there is only freight enough for nine, one vessel will be left without freight. The temptation to cut rates under such conditions is very strong. Finally, fluctuating rates are of the very nature of the charter market, for it is only by high rates at points of ship shortage that the need for ships is manifested and met. With rates constantly changing, it is impossible in practice to maintain uniform rates for all vessels.

As a result of these distinctions, it is impossible to limit competition of tramp vessels by agreements; but it is quite feasible to do so among lines. The Congressional Committee on the Merchant Marine and Fisheries in 1914 concluded, as a result of an investigation, that practically every line engaged in the American foreign trade was a party to one or more of these agreements. Several methods of agreement are commonly employed covering many phases of the business, and there are at least three types of agreements governing rates. The agreement may specify the actual rates to be charged. Such an agreement is difficult to maintain, for ocean freight rates must fluctuate according to the changes in supply and demand for shipping. A liner may have contracted for most of its space at the prescribed rates, but as the sailing day approaches, it may still have some space left, and it desires to obtain a sufficient supply of grain to complete its full cargo. It may be necessary in order to obtain this margin of freight to offer very low rates. This and similar cases are not unusual but occur in the ordinary course of business. Hence agreements providing specific rates must be frequently modified and be subject to several exceptions.

Another type of rate agreement which is not quite so rigid provides certain minima below which rates shall not be quoted. Still a third form of a rate agreement provides for differential rates, giving those lines which are slower or which reach a given port by a roundabout route the right to charge lower rates in

order to neutralize the advantages of the more direct and faster lines.

Rate agreements are often combined with various other understandings in an attempt to prevent competition between the members of the conference. The total freight earnings, or a part of them, may be pooled and divided upon a prearranged basis. By this means, the strongest incentive for cutting rates is removed. Competition may still operate under the pool, for the portion of the earnings alloted to each line has to be revised periodically, and every line desires to show at these times that it has been carrying a larger share of the traffic than is recognized in the allocation of earnings and, hence, that it deserves to be given a larger share of those earnings. As distinguished from this "money pool," there are also traffic pools, which attempt to arrive at the same result by apportioning the traffic instead of the earnings. After a line has received its share of the traffic, it may be required, by the agreement, to raise its rates high enough to divert additional traffic to the other lines. Or the traffic may be diverted in a more arbitrary way. For example, the German lines carrying emigrants had a system of stations in eastern and southeastern Germany through which emigrants passed and were directed to either Hamburg or Bremen according to a fixed ratio of business which the lines operating from these ports were to have.

It can readily be seen that the pool is an unstable arrangement. No line that is at all progressive will be permanently satisfied with a fixed proportion of the traffic. There is a constant demand on the part of each company that it be allowed a larger part of the trade or earnings as the case may be. It is a temporary and rather crude device to remove the incentive for rate cutting. It is often one step on the way to actual consolidation.

Instead of a rate agreement lines may agree to respect as a vested interest the rights of certain lines to the traffic from certain ports. There was apparently an understanding that the Hamburg-American Company would not operate from the port of Bremen while the North German Lloyd agreed not to send its

vessels to Hamburg. In the South American trade one line in the conference was by agreement given the sole right, as far as members of the conference were concerned, to the traffic from New Orleans, while others confined themselves to New York.

When two or more lines are operating from the same port open competition may be avoided, or at least minimized, by apportioning the sailing dates. By this means it is assured that two lines will not be bidding against each other for traffic on a certain day.

In lieu of these formal agreements there are often tacit understandings. For example, two lines may have had the trade of certain Caribbean ports entirely to themselves. Another line, operating to other ports in that region, looks upon their remunerative trade with hungry eyes, but it is restrained from trying to break into the preëmpted field by the certain knowledge that such an attempt would precipitate a freight war that might be carried into its own field. And so it may be that, without any formal agreement, an effective division of the field may be maintained. In like manner a line will be restrained from announcing more frequent sailings in an effort to gain a larger part of the commerce of a port. There is, in other words, whether or not an agreement exists, a perpetual armed truce which all lines fear to break. In many cases such conditions lead to more or less formal agreements.

Relation of Conferences to Outside Lines

It will be noted that all the agreements and devices mentioned represent attempts of the members of the conferences to live peaceably together, rather than follow the foolish policy of the cats of Kilkenny. But another aspect of the activity of the conference lines is found in their attempt to prevent new lines from coming into the field. It is against this external phase of the conference activities that most criticism has been directed. The methods used to maintain their position have often been high-handed and arbitrary. They are similar to those "unfair practices" which have been used by many of our domestic combina-

tions. One of the most effective methods of excluding competitors from a trade is the rebate system. The object of this system is to prevent shippers from giving trade to competing ships outside the conference. The shipper is required to pay, in addition to the regular freight rate, an extra ten per cent which the line returns to him at the end of a specified period, say a year, provided he has not patronized outlaw companies in that time. By this means a shipper is effectively deterred from giving traffic to a new line, unless he is confident that the new line will be able to give regular and permanent service, which in the nature of the case, a new competitor finds it difficult to guarantee. Naturally the new company would start gradually in the field, only establishing regular service as its trade seemed to warrant it. The difficulty of breaking into a preëmpted field under these conditions is enhanced by the fact that the established lines may be operating under an agreement whereby sailing dates are so distributed that the combination of lines can give much better service than could any one of them, or than can any single competitor. For example, three lines may be operating under such an agreement. Between the three this makes possible, let us say, one ship a week although each line has a vessel only once in three weeks. The new competitor would have to provide as frequent service as the three combined lines in order to induce shippers to sever relations with the old lines. This method of holding trade has been used in the trade of the east coast of South America.

The fighting ship has also been used to break down competition. This is a ship, or a number of ships (the Hamburg-American Lines were said to have maintained a whole fleet for that purpose) which starts operations in any field where competition threatens. Rates on these vessels are made low enough to drive out a new competitor. Such rates might well be far below the cost of operation,—the loss being absorbed by the combination as an expense necessary for the maintenance of its profitable business. There is an advantage in using special ships for this purpose, because such ships can more nearly parallel the service of the competitor. It is a method analogous to the local under-

cutting which is now recognized as an unfair practice in interstate commerce.

Similar rate cutting tactics can be employed in aggression as well as in defense. Lines A and B have a profitable trade to themselves and are operating on an agreement to maintain rates. C desires to be admitted to the pool and naturally the permission is refused. If C has sufficient resources it may cut rates and the remunerative business is thereby demoralized. If it appears that the intruder will be able to endure the strain longer than the conference lines, the ring is broken and the new line is admitted to the trade. Rates will then be placed back on their old level, but there will be three diners at the table instead of two.

The two groups of activities of conferences should be distinguished. The one has as its object the regulation of rates, sailing dates, and other practices of the members of the conferences. The other aims at excluding outsiders from the trade covered by the conferences. The former object is attained by rate agreements, money pools, traffic pools, and allocation of sailing dates. The latter is accomplished by the rebate system and fighting ships. The employment of these last named expedients is now prohibited in trade with this country by the United States Shipping Act. The former activities are not specifically prohibited, but all members of conferences are required to file the terms of agreement with the United States Shipping Board, which, in turn, is charged with the duty of investigating such agreements and taking steps to prevent their use for the purpose of unduly raising rates or of discriminating among shippers.

Advantages of These Agreements

As a matter of fact, the existence of agreements and activities of the first class is not without its advantages to shippers. Sound commerce demands a degree of stability in the conditions surrounding its transactions. With a rate war in progress, foreign buyers have no basis for predicting the cost of the product laid down at their ports. Uniform and stable rates are as much a boon

to the shipper as to the carrier. Several of the witnesses before the congressional committee referred to above emphasized the point that they were much more concerned with stability of rates and relative fairness of rates than they were in the level of rates. It appeared to be the concensus of opinion of the many shippers who testified before this committee that the influence of the conferences on rates was salutary. More specifically, this stability of rates makes it easier for the exporter to quote prices on a C. I. F. (cost, insurance, and freight) basis. It reduces the number of complaints from foreign buyers in case they pay the freight. Such complaints are likely to arise either because the actual freight charged was higher than the buyer anticipated, or because he finds that a competing merchant, perhaps in his own port, has received goods at a considerably lower freight charge. In much of our foreign trade ocean freight constitutes such a large part of the cost of the goods that it is really a vital matter. A considerable part of our foreign trade, as also our domestic trade, is handled on a basis which calls for production of goods for order rather than for stock. This is a tendency which the seller desires to encourage, but it is dependent in foreign trade upon an assurance of reasonably stable freight rates. In like manner, the desired regularity of purchases is also dependent upon this factor. When rates are fluctuating there is a tendency for buyers to hold off until rates are low and then try to rush their goods through at the favorable rates. In brief, an increased degree of stability of freight rates tends to remove one important element of uncertainty in the conduct of foreign trade.

Besides rates, the shippers are also interested in frequent and regular sailings on all routes. If two lines are operating on each route and each has vessels enough to provide two sailings a month it is desirable, from the point of view of all concerned, that the sailings should be so arranged that there will be a vessel leaving port each week rather than that both lines should sail at almost the same time. It might seem that vessel operators would not be foolish enough to follow any other policy even without formal agreement, but it must be remembered that without such agree-

ment the primary object is often to injure one's competitors and drive them out of the trade. A further advantage claimed for these agreements is the freedom given the lines in resisting the demands of certain large shippers for favorable rates and treatment. Both operators and shippers testify that the practice of favoritism is discouraged by agreement between the lines. The warmest support given the conferences in the investigation already mentioned came from the comparatively small shippers, the "independents" who were selling goods in competition with larger companies.

Ocean transportation, as has been suggested above, is in its unfettered state a most highly competitive business. Rate wars and sailings on the same date are not exceptions but constitute the natural state of affairs, just as at some periods of history war was the normal state of international affairs and the intervening peace only a temporary truce. In such a business, regulation of some kind is essential to that stability and certainty which is necessary for the best development of trade. But at the same time the control must be flexible enough to meet the constantly changing conditions of demand for, and supply of, shipping services. This latter consideration is a potent argument against any thorough or detailed regulation by a governmental body. It suggests either (1) such conference agreements as are now common or (2) consolidation of small lines into larger groups.

The power to limit competition is never absolute. There nearly always remains a competition in service if not in rates. No line can rely entirely upon the trade allocated to it by the group, for it is always realized that these agreements are more or less temporary and that every other member is trying to strengthen its position with the shippers. Even as to rates the power of the conference is limited by the fact that new lines may, and often do, try to break into the field and that they often work such havoc with their rate cutting that they are finally admitted to participation in the trade. Rates cannot be set at a too high level without inviting this kind of competition.

Tramps also offer effective competition, especially in the lower

classes of liner traffic. It is an easy matter for an enterprising broker to charter a vessel and place it "on the berth," *i. e.*, to offer space to small shippers on much the same basis as that employed by lines. In such cases rates may be so low that the trade of the lines will suffer. Again, if rates remain too high several tramps may come together under a single control and operate as a line, at least for the time being.

The regional competition mentioned above continues to operate even under conference control. A conference of lines serving one region is deterred from raising its rates unduly by the fact that to do so would place the exporters of its region at a disadvantage in competition with the exporters of other regions. The prosperity of a conference of lines, as of individual lines, is dependent upon the active business of the region which it serves.

A view often expressed and more often implied in popular discussions of our foreign trade is that one of the purposes, or certainly one of the results, of agreements of the kind mentioned, when effected by foreign lines touching at our ports, is to discriminate against and hamper the development of American trade. A statement of some of the assumptions upon which such a view must rest, will demonstrate the unreasonableness of the conclusion. Such a statement must assume that shipowners are controlled by motives quite different from those which guide other business men. They must be assumed to be more interested in advancing the interests of exporters of their own nationality than in making profits for their own company. But shipping men are much the same as other business men. They operate where the rates are most favorable and where the highest profits are to be made. While they are no doubt patriotic, there is little evidence that they permit their patriotism to interfere materially with their search for profits. It must further be assumed that a foreign company, having established a profitable service, for example from New York to South America, is going to discourage the growth of that traffic deliberately in order that exporters in London may make greater profits. The interests of the carrier are necessarily bound up with the prosperity of the trade in which it

is operating. While it is conceivable that one company, under the stimulus of subsidies from its own government, might choose to operate from the ports of its own country, it is hardly probable that they would devote their time to building up an American trade only to destroy it. And even if such a possibility existed, it would still more tax the imagination to believe that all available carriers could be brought to follow this unbusinesslike policy.

Doubt is further thrown upon this position by the fact that criticism abroad is the opposite of that heard in this country. Thus the objection of the British government to shipping agreements some years ago was partly based upon the fact that English shipping companies were at that time giving lower rates from New York to South Africa than other companies were giving from England to the same region. The explanation given by the lines was that the New York trade was new and needed the encouragement; in other words, the policy was one of charging what the traffic would bear or, as one student has aptly put it, "not charging what the traffic will *not* bear."

The Committee on Merchant Marine, whose findings were cited above, made a most exhaustive investigation of shipping agreements; but it presented no evidence to show, nor did it suggest in its conclusions that there existed, any discrimination in which the nationality of the shippers was a major factor. This is the more conclusive because the existence of this popular notion was one of the important reasons for undertaking the investigation.

This belief of so many Americans is a manifestation of the widespread opinion that we must have American export houses, agents, ships, and banks in order to sell American goods. The point is very much exaggerated. This view is much more common here than in countries having a much longer experience as foreign traders. The English, for example, have not hesitated to use German agents and German houses have often employed agents of the nationality of their chief competitors, even in those backward countries where the competition is keen. Americans will undoubtedly continue to go into foreign trade in increasing

numbers, but if they are successful and establish such substantial and profitable trade as have many English companies, they will learn that the first maxim of all trade—buy in the cheapest market and sell in the dearest market—is at the basis of foreign trade as truly as it is the guiding principle of trade within the home country.

Consolidation of Lines

A tendency toward consolidation of lines into great systems has been noticeable in the past two decades, although two of the greatest of these systems, the Hamburg-American and North German Lloyd, have been broken in the general collapse of German shipping growing out of the war. There are to-day two types of institutions for the ownership of lines. One is the company which owns but one line which is operated, perhaps under agreements with other lines but still with essential independence. This has been until recently the characteristic type of ownership of British and American lines. The other type involves the control of several lines by one company. The best example was the Hamburg-American Company which owned or controlled 431 vessels in 1914, operating on regular routes in many parts of the world. The English have favored the individual lines, as they have favored tramp vessels over liners of any kind, but before the war it was becoming apparent to them that the "omnibus" companies had certain marked advantages. In such a system "through" bills of lading are used and thereby freight is naturally diverted to other lines in the system. Furthermore, they would be in a more favorable position to employ fighting ships and the other more reprehensible practices noted above than are the individual lines, and, indeed, the use of such weapons has been charged against them.

A combination which has attracted much attention of shipping men, the general public, and even of the governments involved, was that effected in 1902 by the late J. Pierpont Morgan and other American capitalists, whereby they brought under a single control several of the trans-Atlantic lines, principally Brit-

ish. The stock of the new company, the International Mercantile Marine, was held partly by English and partly by American investors. While a majority of the stock was, and no doubt still is held in this country, the ships remain, in large part, under British registry. There were certain advantages in retaining the British registry, not the least of which was the British mail subsidies. The British government was, of course, interested in this foreign ownership of some of their best vessels, and so an agreement was finally made between the British Board of Trade and the Admiralty on the one side and the new American corporation on the other. Under the terms of this agreement the British vessels taken over were to remain under the British flag, one-half of any future additions to the fleet were to be so registered, and these vessels were to be kept at the disposal of the British government in case of need. On its part the British government agreed to continue to extend to the vessels their British privileges.

These consolidations can be viewed as a natural development beyond the stage of pools and rate agreements. Beside the advantage of stability of rates which results from conference agreements, a single ownership of lines facilitates, to a greater degree, the easy transfer of goods from one line to another, a part of the service which is very important, as will appear in the next chapter.

CHAPTER XII

BUSINESS RELATIONS OF SHIPPERS AND CARRIERS

The business relations of shippers and ocean carriers are in many respects different from those existing between shippers and railroads in inland trade. The former are much more complicated and require much more of the shipper's attention than do the latter.

Quoting Rates

There is no such stability and uniformity in the freight rates charged by ocean steamships as are found in the tariffs of railroads. As regards tramp vessels, all rates are made as a result of special negotiations between shippers and carriers or between their representatives. Even with ocean lines a rate tariff does not have the same significance as it does with railroads. In the case of the latter a shipper can rely upon a published tariff, because the rates quoted therein are binding and can only be changed by the railroad after filing a new tariff with the Interstate Commerce Commission and then waiting for a prescribed period. With ocean lines there is no requirement that they publish rates at all, and if they do so the tariffs are for information only and subject to change without notice. The degree to which lines adhere to published tariffs differs among the various trades and the several lines in those trades. But frequently a shipper can only ascertain with assurance the rate to be charged by making specific inquiry based on the particular shipment.

The first step, therefore, in making a single shipment by liner is to inquire the rate. When a rate is quoted for a certain shipment it constitutes an offer on the part of the carrier. If the shipper wishes to make this rate binding he must accept the proposal promptly at the rate quoted. Such an acceptance

amounts to engaging space on the vessel specified. The carrier then reserves the required space and delivers to the shipper or his agent a shipping permit. This "permit" is addressed to the receiving clerk at the dock authorizing him to accept the articles specified from the shipper for transportation on a certain date, and the time during which the shipper shall deliver the goods to the carrier is indicated. Space having been engaged, it is important that the shipper deliver his goods during the specified time as the carrier reserves the right to charge for the space whether the shipment is ready or not. In practice this right is not often exercised, but the carrier can demand payment if it so desires.

When the goods are delivered at the dock the shipping permit is exchanged for a dock receipt, which is a brief statement from the carrier's representative at the dock indicating that the shipment has been received in apparent good order. This is a temporary receipt which must be exchanged for the regular ocean bill of lading before the vessel sails.

It will be seen that the negotiations between the shipper and carrier in ocean transportation involve a greater number of details than in the case of land transportation. In railroad transportation the rates and conditions are established in advance of a particular shipment and are open and available to all. The railroad's published tariff constitutes a general offer on the part of the carrier, which is accepted by the shipper by merely delivering the goods, packed and ready for shipment. In ocean transportation the offer is specific as to shipper, goods, time, and conditions of shipment and is accepted by engaging space which is to be reserved for this specific shipment.

The problem of handling ocean shipments is made still more difficult, especially for the shipper who has been accustomed only to the methods of the railroads, by the terms employed in quoting rates. Quotations of freight rates by the lines are sometimes given in weight units, sometimes in units of cubic feet, and sometimes in terms both of weight and measure, in which case the carrier reserves the right to apply that method of meas-

urement which will yield the larger return. This latter method of quotation is expressed as so much a ton, weight or measure (W/M). The weight ton is the long ton of 2,240 pounds; the measurement ton is 40 cubic feet. The measurement ton of 40 cubic feet should not be confused with the unit used in measuring the net registered tonnage of a vessel. In the latter case a ton is equal to 100 cubic feet of space in the vessel. One is a cargo ton; the other a ship ton. The former is significant to the shipper of less than shipload lots; the other is of interest to the large shipper who is chartering a vessel. Those heavy products which "weigh more than they measure" will be charged for by weight, and light bulky articles will be charged for according to the space they occupy. In addition to these methods there are many special units used in expressing the rates on specific commodities.

The Bill of Lading

The ocean bill of lading is the essential document in making a shipment. It, therefore, deserves consideration at this point. A bill of lading presents three aspects. First, it is a receipt for the goods. The first statement of a typical bill of lading covers this—"Received at New York, by the New York and Cuba Mail Steamship Company - - - from the shipper named on the back hereof, the packages described - - - in apparent good order and condition - - - ." Second, it is a contract for the performance of certain services upon certain conditions. This contract is briefly stated in the continuation of the above sentence " - - - to be transported by steamship named - - - to the destination named - - - or as near thereto as the vessel can safely get, and there delivered in like order and condition - - - to the consignee - - - or order if so provided - - - ." These two aspects of the bill appear on the face of the document, but as a result of these provisions it serves also as an evidence of ownership of the goods described, and when made "to order" it becomes in practice a negotiable instrument used as security for loans and other purposes. When drawn in this way it is

known as an order bill of lading. No consignee is mentioned in the contract proper, but the carrier requires that the name of the party who is expected to receive the goods and who is to be notified upon their arrival at destination be noted in the margin of the document. This notification clause confers no legal rights upon the person so named. Title to the goods passes only upon the indorsement and delivery of the bill by the shipper. Such indorsement may be either special or general, *i. e.*, it may transfer the title to the possessor of the bill or it may transfer the title to a specified party.

The straight bill of lading, on the other hand, is made to a special consignee. Such a document is not negotiable. In practice goods consigned upon a straight bill of lading will usually be delivered by the carrier to the consignee upon his delivering a properly indorsed notice of arrival or establishing his identity to the satisfaction of the carrier, even if he does not present the bill of lading. This, of course, is perfectly proper, because the title has passed to a known consignee by the act of making out the bill of lading and delivering the goods to the carrier. With the order bill the title may pass several times all unknown to the carrier.

Order bills of lading offer great advantages and are the basis for the most common method of collection and finance. This method is the use of the documentary draft. A draft is drawn upon the buyer for the amount of the purchase; the draft is sold in the exporting country with the indorsed bill of lading attached. It is then sent to a banker in the buyer's country, who yields the bill of lading to the buyer only when the demands of the draft have been satisfied. This procedure will be discussed more fully in another place; it is mentioned here only to indicate that the bill of lading is in practice much more than a shipping document.

If the student will compare a railroad bill of lading with an ocean bill of lading he will be struck by the many limitations placed upon the liability of the carrier in the latter as compared with the former document. A railroad is liable for all loss or

damage to the goods with certain exceptions, such as damage arising from an act of God, from acts of a public enemy, or by the authority of law. In certain circumstances, such as the carriage of goods in open cars, the railroad's liability is limited to damage resulting from the carrier's negligence, but the burden is upon the carrier to prove freedom from such negligence. Thus the railroad is generally liable for loss or damage whether or not they arise from its neglect or fault.

In ocean transportation, on the other hand, the carrier's liability is limited by a great number of provisions of the bill of lading most of which also are covered both by the common law and by the "Harter Act," a law of the United States passed in 1893, applying to all vessels carrying goods to or from the United States. The carrier is absolved from all liability for damage caused by occurrences beyond the carrier's reasonable control; by fire or explosion from any cause; by barratry, theft, or embezzlement of the master or crew; by any latent defect of the vessel, even though existing at the time of sailing; by faults or errors in the management of the vessel, provided only that due care shall have been exercised to make the vessel seaworthy and properly manned. These exemptions from liability are only illustrative, but they show that there is no general liability such as rests upon the railroad. Liability can be attached to the carrier in only a few cases, and then only when the shipper can establish the fact that the loss occurred as a result of a lack of due care. These many exemptions from liability explain the importance of marine insurance, as the nature of the railroad bill of lading explains the absence of insurance on railroad shipments.

There are usually at least three original bills of lading besides several more unsigned duplicates for purposes of record. In the case of the straight bill one original is sent to the consignee, another is required by the carrier, and the third is retained by the shipper. The banker will require one and sometimes more than one order bill. Any one original copy of an order bill of lading is sufficient to obtain the goods. Therefore, it is provided in the bill that the carrier "hath signed three bills of lading,

all of this tenor and date, one whereof being accomplished the others to stand void."

A "clean" bill of lading is the usual bill in which the carrier accepts the goods as being in apparent good order and condition. In case the packages are broken or weak the carrier will sign a bill of lading only when this fact has been noted in it. A bill thus modified is known as a "foul" bill. The distinction is of significance to the shipper, as banks will be chary in accepting a "foul" bill as collateral for a draft.

It appears from the preceding description of the requirements of making an ocean shipment that there are a great number of details to be arranged and that there is necessarily some uncertainty among shippers as to the cost of transportation arising from the lack of publicity, uniformity, and stability of rates. Various devices are used to overcome these difficulties. The most common method is to employ a freight forwarder.

The Freight Forwarder

The forwarder is stationed at the port and handles the shipments of exporters at interior points. He is an intermediary between the shipper and the carrier. When goods are ready for shipment from the interior point they are delivered to the railroad and consigned to a freight forwarder at the port. The forwarder is notified that the goods have been shipped, and he is supplied with all necessary information and instructions to enable him to carry out his work. If the shipment is large, the freight forwarder, upon receiving such advice, decides upon the best route, from the point of view of time and other factors of service, and then makes inquiries of the steamship lines concerning sailing dates and rates. On the basis of this information he engages space for the shipment. If, on the other hand, the shipment is small he may plan to combine it with other lots of goods intrusted to him and destined for the same port. In that case, of course, it will be unnecessary to make special space reservation.

When the goods arrive at the railroad terminal the forwarder receives them, and in the case of the large shipment he will trans-

fer the goods directly to the steamship lines with which he has made previous arrangement. The steamship line issues to him first a dock receipt and later a complete set of ocean bills of lading covering this specific shipment. These will be handled according to the exporter's directions. If the shipment is small it will be taken to the forwarder's warehouse, where it will be assembled with other goods. Sometimes repacking or other preparation of the goods for shipment is necessary. Then the lot of goods is delivered to the ship, to all intents and purposes a shipment by the forwarder himself. A single set of ocean bills of lading is issued to the forwarder, who, in turn, issues his own bills of lading to the several exporters represented. These forwarders' bills of lading are less desirable for some purposes than the ocean bill of lading. Banks and the foreign customers do not consider them as desirable, for they do not indicate that the goods have actually been placed on board the vessel. With small shipments, however, this is not always a vital consideration.

The activities described all have to do with transportation and they constitute the primary task of the freight forwarder. Other functions, however, are also performed by him. Many foreign countries to which goods are exported require certain documents to be made out before the consuls of those countries and sometimes in the language of the country of destination. Among these are consular invoices and certificates of origin. The former are invoices of the shipments made according to detailed requirements and signed before the foreign consul. The latter are certificates establishing the country of the origin of the goods. Requirement in these respects vary widely between the several countries of destination and a detailed knowledge of these requirements is essential. The forwarder commonly acts as an agent of the shipper in preparing these documents. Then our own government requires an export declaration to be made and filed with American authorities. These declarations form the basis of all export statistics, such as were presented in a preceding chapter of this book. The forwarder also attends to this requirement.

All goods shipped by ocean carrier should be insured. This insurance may be arranged by a separate broker but forwarders sometimes engage insurance. They sometimes act as intermediaries in the performance of the finance function by turning over the necessary documents, together with a draft, to a bank. This may be a bank specified by the exporter, or the forwarder may use his own judgment in this matter. The forwarder is not engaged in the finance function in the sense that he advances any considerable funds himself, but he may be a valuable intermediary.

Some of the advantages offered by the forwarders should be apparent from the description of their activities. As far as transportation is concerned the chief advantages to the exporter of large lots of goods are in being relieved of many troublesome details and in getting goods moved promptly through the port. To the exporters of small lots there is, in addition to the advantages just noted, a considerable saving due to the fact that by combining shipments the forwarder obtains better freight rates than could the individual exporters. He can secure better rates because of the practice of steamships of giving proportionately lower rates for large shipments than for small ones. The exporters may pay more than does the forwarder but still less than they would have to pay if they themselves shipped their goods.

The forwarder is employed in importing as well as in exporting. Here he attends to entering goods at the customs house and transferring them to the railroads. The forwarder is not in any case a middleman of purchase and sale. In this he is distinguished from the commission house which performs forwarding work in addition to its other functions. He is rather an agent of the exporter or importer—in a figurative sense, a part of the exporter's or importer's traffic department.

When the foreign trade of any manufacturer passes through the hands of an export commission house all the problems of transportation can, of course, be dismissed, for the responsibility rests squarely upon the commission house. That is to say, the export commission house combines the selling function with the

function of physical distribution of the goods. It acts in the performance of this part of its work either on its own account or for the foreign buyer or for the seller. The same house sometimes acts as export commission house, performing all the tasks of selling, finance, and other marketing functions, and also serves other clients as forwarder only.

The International Express

Another service, similar in many respects to that of the foreign freight forwarder, is the international express service. This express service should be clearly distinguished from the domestic express service, from which it differs materially. One of the essential characteristics of the domestic express service is that goods intrusted to the express companies are forwarded by a different class of trains than is ordinary freight. The volume of international traffic, however, is too small to justify the employment of special facilities. Express goes forward by the same vessels as handle freight, consequently very little time can be saved by the express service as compared with ordinary freight service. The justification, therefore, for the existence of the express service must be found in the special forwarding and other services offered.

Another distinction is that, whereas the domestic express company reserves certain space on passenger trains by the year or other long period of time, the international express company provides itself with shipping space in the same way as would an ordinary shipper. That is to say, it books space as it is needed from time to time and at the rates which may at the time be prevailing. Thus on every shipment of goods the foreign express company receives from the carrier a separate bill of lading. To the shipper it issues either an express receipt, similar to that used in domestic express service or, if the shipment is large, its own bill of lading. As a result it is impossible for the international express companies to give to their quoted rates the same degree of stability as is found in the domestic express tariffs.

A third characteristic of this express service, and one which is

sometimes overlooked by the shipper, is that these so-called express companies do not provide the same facilities for delivering to destination as is provided by the domestic express service. In only a very few of the most important cities of Europe are delivery systems maintained.

For very small shipments the International Parcel Post is coming into increasing popularity. For shipments somewhat larger, but still small as ocean shipments go, the steamship lines themselves now provide special rates giving a parcel receipt instead of the more comprehensive bill of lading. These two possibilities, as well as the large number of freight forwarders, make these devices formidable competitors of the international express system in the handling of small lots of goods.

The Through-Export Bill of Lading

Another method of avoiding the difficulties of transferring goods at the port of shipment and arranging for ship services is the "through-export" bill of lading. Such a bill of lading is issued by the railroad companies in conjunction with steamship lines. It covers the shipment from the interior point in this country to the foreign port or possibly to an interior point in the foreign country. It thus involves two and possibly three carriers: the American railroad, the steamship line, and the foreign railroad. The through bill of lading contains three distinct parts each of which is a contract for one of the three parts of the service to be rendered. On such an arrangement a railroad may merely act as a forwarder of freight in addition to its primary rôle. In this event it engages freight space on ocean vessels at the prevailing rates as would any other shipper. On the other hand, it may be working in close relation with the ocean carriers and thus be able to quote a through rate exactly as it would quote a rate on an all-rail shipment. This practice is difficult, however, for ocean rates are subject to constant change and the railroad often finds it impossible to file tariffs on ocean and rail shipments under the legal requirement that they be not changed for a period of thirty days.

In the past, through-export bills of lading have been issued only by certain railroads and then ordinarily upon carload shipments of goods. In 1920, however, the Interstate Commerce Act was so amended as to require railroads to issue such bills under the first plan just described, *i. e.*, special arrangements for each shipment. "It shall be the duty of the carrier by railroad to deliver such shipment to the vessel as a part of its undertaking as a common carrier." These requirements are restricted to ships under American registry.

In so far as shippers avail themselves of this opportunity, it is unnecessary to employ a freight forwarder to look after transportation. Most of the advantages are, therefore, apparent from the description of the activities of the forwarder. In addition, the exporter knows the rate for the complete shipment at the time the goods leave his hands. He can, therefore, make finance arrangements with his own bank. The goods remain in the custody of the railroad until delivered to the ship,—an advantage to the exporter who is not acquainted with the several freight forwarders. The charges for transfer at the port are definitely fixed in advance as a part of the railroad's charges and are also, it would seem, subject to review by the Interstate Commerce Commission.

On the other hand, there are disadvantages in adopting this method in lieu of the services of the forwarder. The forwarder, as noted, performs many other functions than those connected with transportation. In selecting an ocean carrier there are sometimes savings to be made in the freight rate by giving attention to liner competition. Again, the foreign customer sometimes has a distinct preference for an ocean bill of lading over a railroad bill. The one indicates actual acceptance of the goods by the steamship company, which has representatives in his country; the other merely indicates acceptance by the railroad for shipment. Foreign banks may object to such bills unless the customer has given his consent to their use. As a matter of fact, to the present time the new railroad bills of lading have not been used to the extent that might have been expected. This may, of

course, be due merely to inertia or it may indicate inherent weaknesses in the method.

Agents for Ship Chartering

In the preceding discussion of middlemen and agents employed in handling shipments, only that freight going by liners has been considered. The large volume of staple products such as cotton, iron ore, coal, lumber, and to some extent, grain, are shipped in chartered vessels. A whole vessel is rented or hired either for a specific trip or for a specified time. Inasmuch as the rates for these charters are constantly changing, due to a bewildering complexity of factors, the shipper, even one handling goods in shipload lots, is not in a position to appraise the rate situation properly and decide wisely in engaging a vessel. There has grown up a class of brokers, therefore, who will make such arrangements in the name of the shipper. They are known as ship brokers, and the largest part of the freight chartering is handled through them.

The shipowner or operator on his part, may also employ an agent to look after chartering the vessel for him. This agent will have his own representatives or correspondents in the principal ports. Thus between the shipper and carrier there may function two specialists—one representing the carrier and the other the shipper. Or one agent may act as the sole intermediary, collecting his fee from the carrier. Charter agreements are drawn up by such agent or agents, although commonly final decision is referred back to the principals.

The contract between the shipper and the ship contractor is known as a "charter party." It bears somewhat the same relation to these large shipments on tramps as does the bill of lading to smaller shipments in the regular liner service.

Freight carriers can be employed by shippers on various bases. A shipper may choose to engage the whole vessel, and in that case the vessel usually is employed under a trip charter, according to which the lessor agrees to carry a cargo of a specified commodity over a specified route with reasonable dispatch. The rate paid is expressed in terms of a unit of the product. The transaction

may be either on the "net form" or on the "gross form." In the former case the operator is responsible only for actual transportation; in the latter he is responsible for both loading and unloading. Unless the shipper is familiar with conditions at the port of destination or has an agent there to receive the goods, the gross form is advisable.

For the shipper who is sending less than shipload quantities of freight there is the possibility of engaging space in a tramp vessel which has been put on the berth. An operator of a tramp vessel may observe that there is a plentiful supply of freight in less than shipload quantities to certain ports or to a general region. He may, therefore, decide to make a trip in this trade. He advertises that shipping space will be available on his vessel and fixes a definite sailing date. This practice is more common in some ports than in others. It is more frequent in those ports in which a larger volume of freight is received than dispatched. Under such a condition tramp vessels will find it difficult to obtain a regular charter for the outward voyage. For example, it is reported that the practice is fairly common in the ports of Australasia, China, Japan, and in the ports of Europe for vessels loading for America.[1]

In making such arrangements a freight broker may take the initiative of chartering the vessel for his own account and then retail the space on his own terms. In so doing, of course, he is acting as an independent operator and not as a broker in the strict use of the term. It will be further observed that the tramp is here performing a service similar to that of the line, in that it accepts freight in less than shipload lots for transportation on a prearranged date and route.

[1] J. Russel Smith, *The Organization of Ocean Commerce*, p. 48.

CHAPTER XIII

FINANCING FOREIGN TRADE

The problem of financing the distribution of goods engages much of the attention of exporters and importers. Like transportation, it is one of the marketing functions common to all trade, but, also like transportation, its performance in foreign trade is more difficult than in domestic trade, and a special technique has been developed for handling it. Some of the problems connected with this subject, particularly those arising from the variety of monetary units employed, have been discussed under the head of foreign exchange. The present chapter deals particularly with those phases of the subject incident to the time elapsing during distribution.

The Nature of the Finance Function

In our modern economic organization considerable time usually intervenes between the production of goods and their consumption. During this time the wealth embodied in the goods is nonproductive and the owner of the wealth is deprived of its use. Therefore, the waiting for this wealth to "ripen" into final consumption utilities or, from the point of view of the producer, into free purchasing power, is a real burden. This burden may be borne by the producer if final payment is deferred until the time of consumption; it may be borne by the consumer if payment is made in advance of consumption; it may be shifted to a third party, a middleman, when such a party is willing to advance the payment to the producer and defer collection from the consumer. In any event, the finance function exists because of the time intervening between production and consumption and its existence is independent of any arbitrary requirements of producers, consumers, or middlemen.

Some time must intervene between the purchases of raw materials by the manufacturer and the final production of the manufactured article. This period of waiting is likewise a burden, but it is commonly and properly considered a manufacturing cost and is borne immediately by the producer. Likewise some time ordinarily intervenes between the purchase of goods by the final consumer and their actual consumption. The resulting burden is ordinarily assumed directly by the consumer. The time intervening between the manufacture of the product by the producer and its final sale to the consumer is a cost of distribution and is properly assumed by the manufacturer in his capacity of distributor of his own products or by some of the middlemen who handle the products. All of these costs under free competition tend to be included in the price of the product, and thus to be borne by the final consumer. This is equally true whether the financing be performed by producers, merchants, or banks.

The finance burden should be distinguished from the risk element which is involved in extending credit. The extension of credit commonly entails two burdens: one, the waiting for payment and the other, the risk of payment's not being made. As the terms are employed here the former is recognized as the finance function, the second as a part of the risk function. In the discussion of the technique of finance it is not always possible to treat the two separately, but they are, nevertheless, different in nature.

This finance burden is more onerous in some countries than in others. It weighs most heavily in countries where the supply of capital is small in proportion to the demand for it and, hence, where the interest rate is high, and less heavily in countries where there is a plentiful supply of funds and where, therefore, some one can always be found to relieve the producer of the financial burden for a small remuneration. It follows, therefore, that the cost incurred on this account is somewhat lower in a country like England, where the supply of loanable funds is great and the interest rate normally low, than in the United States, where opposite conditions tend to prevail. This suggests that the handicap under

which American manufacturers are said to labor in financing foreign trade, arises from factors more fundamental than lack of experience or the presence or absence of a particular system of financing. Production costs being the same in two exporting countries, importers can normally buy on more favorable terms from the country having the lower interest rates, unless, indeed, a country of high interest rates employs the low-interest country to finance its foreign sales. That this international division of labor does exist will be seen as we proceed.

Ordinarily both the producer and the final seller try to relieve themselves of the finance burden. The manufacturer can profitably employ all of his capital in the purchase of raw materials and the production of goods, and he does not wish to tie it up in accounts receivable. The final seller likewise wishes to do the largest possible business with a given amount of capital, and he looks to purely mercantile transactions for his profit. It, therefore, has become common for both buyer and seller to turn to the banks or other third parties who specialize in the performance of this function. If, however, the manufacturer has accumulated a large reserve which is not needed in manufacturing, he may prefer to perform this function himself, charging the buyer of the goods for the service. Likewise, in slack times when there is little demand for funds in production, he will more freely extend long terms and will bear the finance burden himself. The retailer, for similar reasons and under similar conditions, may occasionally be glad to use his funds in this way. These conditions, however, are exceptional, and ordinarily the services of financial specialists are utilized whenever possible.

Factors which Determine the Credit Term

From what has been said concerning the nature of the finance function, it will be clear that the length of credit time extended in the sale of goods should be correlated to the time necessary for final disposal of the goods. For example, in a retail line in which the average rate of turnover is twelve a year, mercantile credit may properly run for thirty days, while, in a line in which the

stock normally turns but twice a year, credit might be extended for as long as six months. A longer extension of time means that the creditor is extending more credit than is necessary for the handling of his goods. Consistent with this principle, there is in fact a noticeable correspondence between the rate of turnover and the customary credit terms.

Since the rate of turnover varies from country to country and other conditions likewise differ, it will be apparent that economically justifiable credit terms will vary widely between markets. American manufacturers, accustomed to the short terms prevailing in the domestic market, often consider the requests made by their foreign customers for three months, six months, and nine months time as unreasonable, and they sometimes even refrain from entering the foreign field on this account.

Longer credit periods in the foreign trade than in the domestic trade are justified. In the first place, considerable time must elapse even between the shipment of goods and their receipt by the foreign buyer. Another period is involved in returning payment to the seller. Therefore, considerable time must be granted by the seller, even though the buyer pays for the goods as soon as he receives them. While this period of waiting is a burden to the seller, it cannot be considered an extension of credit from the point of view of the buyer.

As noted above, the length of credit time which is justifiable depends upon the rate of turnover. The rate of turnover, in turn, depends upon the size of stock which it is necessary to carry in order to do a certain volume of business. When a merchant customarily depends upon foreign sources of supply it is clear that a larger stock must be carried, in proportion to the volume of trade, than when the goods are purchased from nearby producers who can supply the needed goods on very short notice. This larger stock tends to slow up the rate of turnover of dealers who depend upon imported goods and justifies a demand for liberal credit terms.

These conditions apply to our foreign trade without regard to the peculiar conditions existing in particular markets. In our

trade with Asia, Africa, South America, and other relatively undeveloped countries, there are additional factors which justify longer credit terms. Dealers in such countries are likely to be operating with rather small capital. Interest rates in these regions are likely to be high and the supply of loanable funds small. It is difficult, therefore, for the buyer to turn to the banks for assistance in financing his purchases. Often the trade of the country is dependent upon one or a group of seasonal industries. In such cases the merchant often finds it necessary himself to extend credit to the final consumers, who are dependent upon the annual sale of their products for the ready funds with which to make their payments. An illustration of a similar situation is found in our own southern states, where the storekeepers finance the small farmers and in turn demand long credit from the manufacturers or jobbers. Largely for this reason, we find longer credit terms in the cotton-raising south than in other sections of our country. Another factor, somewhat allied to the seasonal nature of industry, is the seasonal fluctuation in exchange rates in those countries whose exports are made largely at one time of the year. Under such circumstances the buyer is likely to defer payment if possible until such times as the exchange rates are favorable. Foreign buyers, no doubt, do make unreasonable demands for credit terms. There are, however, sound reasons for longer terms in foreign trade than in the domestic trade, and the length of term in some foreign markets is properly longer than in others.

The distribution of the finance burden between buyers, sellers, and middlemen in specific instances will appear incidentally as we proceed to a description of methods of finance. Here it need only be noted that the most important elements in determining the desirability of the various methods of finance which we are now to discuss is, from the point of view of the different parties involved, the location of the finance burden and the risk burden which accompanies it.

It is possible to classify finance methods from the point of view of safety to the seller or from the point of view of the

time allowed for payment. Either of these methods would provide a logical scheme, but we shall here employ neither of them. Rather we shall first describe the most simple methods and then proceed to the more complex.

Payment with Order

The most simple method and the one most satisfactory to the seller is cash with order. Under this plan the buyer sends a bank draft or a money order with his order. The seller is fully protected against all possibility of loss, not only from the time the goods are sent forward, but, in the case of goods made to order, he is relieved of all risk involved in employing his funds in the production of the desired goods. It is obvious, however, that the method would not be desired by the buyer, as he advances funds long before he receives the goods. The objection is well founded, for, not only is the whole finance burden of the commercial transaction placed upon one party, but, in addition, he is asked to bear one of the proper expenses of production. Such an unbalanced method will come into general use only in a "sellers' market" or when the sellers demanding this method are relatively indifferent to the development of the trade.[1] It is employed where small orders are sent to manufacturers by buyers who are little known or with whom business relations have not previously existed.

A more important use for this method of finance is found in the sale of goods which are manufactured to order according to the buyer's specifications. In the manufacture of expensive machinery to particular specifications the manufacturer must rely to an unusual degree upon the good faith of the buyer. Even here, however, payment in full by the buyer is unnecessary. A plan, which calls for one-third of the purchase price with the order, one-third upon shipment and one-third a certain period after receipt

[1] Payment with order is required by many American manufacturers in their foreign sales. It is most noticeable, however, in those countries in which American manufacturers are making no very strenuous effort to develop trade. For a number of consular reports on American terms of sale in specific foreign markets, see A. J. Wolfe, Foreign Credits, Bureau of Foreign and Domestic Commerce, Special Agents' Series, No. 62.

of the goods by the buyer, would seem to give sufficient protection to the manufacturer. This plan is sometimes followed, especially by English manufacturers of machinery. Another plan available in the case of goods requiring a long time to produce is to require a series of payments to be made as the product advances toward completion. These instances serve to emphasize the fact that the generality of goods involved in international commerce cannot be handled on this basis, except under those extraordinary conditions in which the competition of buyers is keen and competition of sellers is practically absent or when the desirability of the purchase from the point of view of quality or price is so great as to offset the onerous terms of sale.

The Open Book Account

At the opposite extreme in credit liberality, stands the open book account. This method is familiar as the common one employed by retailers in advancing credit to their customers. The value of the goods sold is simply charged to the account of the buyer on the seller's books. It is a method much desired by buyers, as it creates no legal obligation to pay at any definitely stated time. This flexibility is a distinct advantage to the foreign importer as it enables him to adjust his payments to the liquidation of his customer's debts to him. Also in those countries in which there are marked fluctuations, seasonal or otherwise, in the exchange rates, it enables payments to be made at times when the exchange market is most favorable. It is a convenient method, especially where a continuous business is being done, as it obviates the necessity of special documents or arrangements with each order.

But the open book method is as undesirable from the point of view of the seller as it is advantageous to the buyer. The risk is enhanced as there is no document bearing the signature of the buyer which acknowledges the existing debt. In case of dispute, the seller must demonstrate, item by item, that the goods were delivered in accordance with the contract of sale. There is considerable advantage in a single document which establishes

once for all the buyer's debt. Aside from the weakness of this method from the legal point of view, the absence of a definite payment date, evidenced by a written statement of the debtor, encourages dilatory practices.

The most obvious weaknesses of the simple open account method are often remedied by informal agreements between the parties. Thus the seller is likely to set a maximum limit, determined by a survey of the buyer's business and his needs, beyond which his indebtedness will not be allowed to run. The buyer may be given a "line of credit" for, say, $1,000. As rapidly as past indebtedness is liquidated new purchases can be made. It is usually understood that payments are to be made at specified intervals, say every six months. That is, the credit is to be turned at least twice a year.

Further, a rate of interest is sometimes charged upon unpaid balances. This of course has the effect of encouraging the buyer to make reasonably prompt payments, although, for this purpose, a series of discounts similar to those used in our domestic trade would probably be more effective.

It is clear that the open account method can be safely used only when the seller is convinced of the integrity of the buyer and the stability of his business. American manufacturers grant open credits in those markets with which they are acquainted, *i. e.*, Canada, Cuba, Mexico, the United Kingdom, and less often, continental Europe. While a considerable number of American firms occasionally use this method, it is nearly always in the nature of an exception made to buyers of unquestioned standing. More particularly, it is employed when two large merchants are doing a reciprocal business in which purchases and sales roughly balance. Under these circumstances, which occasionally exist between importers of raw materials in the industrial countries and importers of manufactured goods in the non-industrial countries, debit and credit entries on the books of the merchants involved take care of current transactions, and settlement of net balances are made at regular periods.

This method is less used at present than it was in the past.

In the early development of modern commerce the merchant adventurer, owning both vessel and cargo, fared forth with a shipload of goods which were bartered or sold as might seem best. As trade grew and merchants desired more permanent connections with foreign markets, they established their agents at the foreign ports. These agents were often members of the parent firm or members of their principals' families. There was little danger in granting the most liberal credit terms. Finally, this business relationship gave way to independent importers. But these were large general importers, well known to merchants the world over. The open account was desired to accommodate the payment of the importers to their receipts from the sale of their goods. The tendency has been, and still is, toward an increasing degree of specialization and a vast increase in the number of importers. Thus the previously existing close relationship and intimate acquaintance of a few great merchants, which made possible the very liberal terms of credit, tends to give way to a more complicated system and more impersonal relationship. Further, the development of modern banking and credit facilities has provided more speedy and safer devices for settlement.

The open account does not, in itself, provide a means of payment. The final settlement must be made by a bank draft made payable to the seller, purchased and sent to him by the buyer, or by a clean draft drawn upon the buyer by the seller. This brings us to the commercial draft, to which, inasmuch as it is the financial basis of all international trade, careful attention must be given.

The Draft

A draft may be defined as an unconditional order of one party upon another to pay a designated sum of money at a determinable future date. Drafts used in international commerce are known as bills of exchange, and for our present purposes the terms may be used as synonymous. A draft drawn by a business man in the collecting of funds due on account of commercial transactions is known as a commercial bill of exchange. When drawn by a banker for whatever reason it is called a banker's bill

or banker's draft. While in principle the two are identical, in practice they differ widely, first, as to security and, second, as to their functions. The security of a draft to any third party holding it depends largely upon the business standing of the drawer.

Since the business standing of a bank is nearly always better than that of a commercial institution, bank drafts have a much higher value and are more generally acceptable by third parties than are commercial drafts. A draft drawn by one bank upon another directing the drawee bank to pay a specified sum of money would be considered by the beneficiary as practically as good as money itself. It may, therefore, be used in the settlement of an open account transaction such as described above. The bank draft may be drawn in such a way as to authorize payment to the exporter or the same result may be attained by another method. The bank may draw the draft payable to the importer who purchased it, and the importer may then indorse it, thus making it payable either to the beneficiary specificially or to any *bona fide* holder, depending upon the form of the indorsement.

The buyer of goods, let us say in Argentina, when he is ready to make payment goes to his bank and by paying the equivalent of his debt, in Argentine money, obtains from his bank an order drawn upon an American bank to pay the amount of his debt in American money. This draft is then sent by the importing merchant to the exporter, who obtains his money from the American bank. The Argentine bank must, of course, have funds on deposit with the American bank out of which the draft can be paid. How, in the ordinary course of trade, such a balance of available funds has been accumulated was explained in the chapter on foreign exchange. Here we need only recall that other Argentine merchants have been selling goods to other Americans, and in obtaining their funds they have drawn commercial bills upon their American debtors. These bills have been sold to the Argentine bank, which has, thereby, parted with funds in Argentina and correspondingly come into possession of funds in the United States. It is against these funds that

the draft is drawn. If the trade with Argentina is not of this reciprocal nature the Argentine bankers will ordinarily not have funds in the New York banks available for meeting these bank drafts. They will then have to draw upon their accounts in some other country to which their merchants have exported, and the drafts will be payable in the currency of that third country. In that event, to follow our illustration, the Argentine debtor would send to his American creditor a bank draft upon, say, London and drawn in pounds sterling. The American would then sell this sterling draft to an American bank, which thereby parts with dollars and obtains pounds sterling in London. Thus the currency of a third country is used as a common international medium.

It will be seen, then, that the use or disuse of the American dollar in international trade rests upon something more fundamental than the whim of traders or the existence of foreign branches of American banks. It also appears that the bank draft rests upon the commercial draft. Further, the commercial draft rests upon the exchange of goods. Thus the exchange of goods for goods is ultimately at the bottom of all international payments. This should be borne in mind throughout the discussion of methods and business practices by which international settlements are made.

The seller instead of waiting for the buyer to take the initiative in buying a banker's draft for remittance to him may himself draw upon the buyer, *i. e.*, a commercial draft, drawn by the seller displaces, or, as we shall see later, possibly supplements the bank draft obtained by the buyer. An understanding as to which method is to be utilized is effected in the sales contract. Thirty days before the time agreed upon for payment the seller might draw up such a draft as illustrated below.

$1551.32 New York, August 1, 1922.

Thirty days after date of this First of Exchange (Second unpaid) pay to the order of ourselves $1,551.32. Payable in legal currency at the bank's drawing rate of the day of payment for sight drafts on New York.

For value received and charge to the account of

To Mr. Richard Roe, Export Corporation,
Buenos Aires, Argentina. Vice-Pres. John Doe.

Certain characteristics of this draft should be noted. It is drawn in the currency of the drawer rather than of the drawee, but it provides for payment in the drawee's currency, the requirement being that a sufficient amount in Argentine money be paid to buy, on the day of payment, a banker's draft upon New York for the face of the draft. The amount which the drawer is to receive is definite. The amount which the drawee is to pay depends in part upon the rate of exchange on the day of settlement. This places the risk of exchange fluctuation completely upon the drawee (the importer). Had the arrangement been that the draft was to be drawn in the currency of the buyer, the situation as to exchange risk would have been reversed. The buyer would have known just how much he was required to pay, and the seller would have received more or less in his own currency according to the condition of the exchanges. The draft might have been drawn in neither dollars nor pesos but in a third currency, say pounds sterling. In that event both buyer and seller would assume a risk of exchange. The buyer would not know in advance how many pesos would be required to buy a draft for the designated amount in pounds, and the seller would not know how many dollars the pounds sterling would yield.

The Clean Draft

Now having drawn up this draft, what can be done with it? First, the drawer may present it to his bank for collection. In rendering this service the bank is not performing its principal function of financing, that is, of advancing its credit, but is merely acting as a known and trusted intermediary. The draft will be indorsed by the drawer and turned over to the New York bank, together with a letter of instructions. This letter of instructions is intended to cover certain contingencies and to authorize the bank to communicate with the drawer in case of need by cable, and it also often names a representative in the foreign country who can be referred to in case of need. The New York bank now sends the draft forward to its correspondent in the city of the drawee, who presents it for payment,

following carefully the instructions of the drawer. Payment being made in pesos, the Argentine bank may issue its own draft upon its balance in the New York bank, or, if the New York bank maintains a balance with the correspondent bank, it may merely deposit the funds to that account and notify the New York bank. Upon being assured that payment has actually been made, the New York bank pays the face of the draft to the drawer. If the bank's collection fees were to be paid by the buyer, they are either passed on by the bank to its correspondent, who collects them from the debtor in addition to the face of the draft, or they are added to the face of the draft. A rather common method is for the seller to pay the fees of his bank, and the buyer to pay the fees of the foreign collecting bank.

In case the draft is merely sent through the banks for collection the seller must wait for payment until the expiration of the time given in the draft and the time necessary for return of funds or notification of payment to the New York bank. This places the finance burden entirely upon the seller. As noted in a previous section, very few business men wish to tie up their capital in this way. Therefore, the New York bank may be called upon to advance funds on the security of the draft.

Serious objections will exist against the bank's financing the transaction just described. The only security of the bank for the recouping of its advance is, first, the probability of the drawee's honoring the draft, and second, the likelihood of the drawer's making good the amount advanced in case of failure by the drawee. The mere drawing of a draft creates no legal obligation upon the drawee. Any obligation of this kind must exist by virtue of some other act and be indicated by some other document. The drawer of the draft, however, does place himself under obligation to any third party who may come into possession of it. True, a draft may be disposed of "without recourse" in which case the drawer is absolved from further responsibility, but if this is done it must be by specific agreement, and in practice it is very rare. Hence the final security of a draft, of whatever kind, is the credit of the drawer.

There is in the clean draft no documentary evidence, indicating that the draft will be honored by the drawee. There is nothing to show that the drawer had any right to draw such a draft; there may be some question of the ability or willingness of the drawee to pay, even though he be under legal obligation to do so. Collection of the draft by legal process is always an expensive and unsatisfactory procedure, even if the suit be successful. The banker must, therefore, rely almost entirely upon the credit standing of the drawer. These are serious weaknesses of this method of financing, and as a result of them it is open to only a very few exporters of the very highest standing. Even with these firms, the advances made on such a draft reduce thereby the amount of their available credit at the bank; the commercial transaction which gave rise to the draft does not in itself induce the banker to issue the credit.[1]

To summarize: drafts of this type are used in the manner described here, only when the seller has the utmost confidence in the buyer. This may exist when the buyer is so well known that his credit is above question, or when long standing relations between buyer and seller have been maintained, or when the drawee is closely connected with the buyer, as is the case of dealings with agents or branch houses. Clean drafts can be made the basis for advances by the bank only when the standing of the drawer is so high as to justify advances of credit independent of any specific transaction. The draft itself is no more serviceable in obtaining an advance of credit than would be a simple promissory note.

The Documentary Draft

In an attempt to overcome these weaknesses from the point of view of both seller and banker, a simple device is employed. This is to make the delivery of goods conditional upon payment, or

[1] Clean drafts may command more favorable prices in the market than documentary drafts. This fact by itself is misleading. Only those establishments of the very highest standing can discount their drafts at all. Clean drafts on the market are, therefore, drawn by a select class of businesses. Comparison should be made, not between clean drafts of the best firms and documentary drafts of inferior firms, but between the two types of paper drawn by the same or similar firms.

a satisfactory guarantee of payment, of the draft. To bring this about the bill of lading, which gives title to the goods, is attached to the draft, and the possession of the bill, and therefore of the goods, can be obtained only by meeting the requirements of the seller. A draft accompanied by documents is a documentary draft; when unaccompanied by documents it is a clean draft. The face of the draft may be the same in the two cases. It will therefore be unnecessary to repeat the description of a draft given above.

The documents which may be attached to the draft are: (1) the ocean bill of lading, (2) the insurance certificate, (3) commercial invoice, (4) consular invoice, (5) certificate of origin, (6) weight certificate, (7) declaration of shipper, (8) hypothecation slip, (9) letter of instruction.[1]

The bill of lading and the insurance certificate are the essential documents. The others may, in whole or in part, be omitted. In practice, however, a documentary draft consists of quite a bundle of documents. The bill of lading is described in detail in the preceding chapter. One of its functions is to serve as an evidence of title to the goods covered by it. To serve this purpose the bill of lading must be made "to order," *i. e.*, to "ourselves" and then indorsed by the shipper. This gives to any rightful possessor of the document a claim upon the goods, and without the delivery of this document properly indorsed the goods cannot be obtained.

The function of the marine insurance certificate is to protect the exporter, or any other party who has a lien upon the goods, against damage to the goods during shipment and transfer to the buyer. It will be recalled that the steamship companies, unlike the railroads, assume only a very limited liability for such damages as may be incurred. This explains the use of the insurance certificate in financing foreign trade and its absence in our domestic trade. The insurance certificate, like the bill of lading, is indorsed by the exporter in case the shipment is made the basis for an advance of funds.

[1] Furniss, E. S., *Foreign Exchange.*

The draft, together with the documents, may be sent through the banks for collection. The documentary draft is superior for this purpose to the clean draft, because the exporter retains control of the goods until payment or a satisfactory arrangement for payment has been made. The documentary draft thus serves a definite purpose for the exporter himself—that of insuring collection. This, it should be noted, is in addition to any value which it may have as collateral security for an advance of funds by a bank.

The arrangements which may lead to the delivery of the documents may be either acceptance of the draft or payment of the draft. By acceptance of the draft is meant the acknowledgment by the drawee of his obligation to pay. It will be recalled that a draft in itself is merely a drawer's order to the drawee to pay a certain amount of money. In no way can it be construed as a promise of the drawee to satisfy this demand. If, however, when the draft is presented to him, calling for payment some time in the future, the drawee writes "accepted" across the face of the draft, indicating the date, and signing his name, the draft becomes the obligation of the drawee as well as the obligation of the drawer. It is now known as an acceptance and is legally similar to a promissory note of the acceptor, except that it gives evidence of the contingent liability of the drawer in addition to the promise of the acceptor.

The drawer of the draft may be willing to relinquish control over the documents upon acceptance of the draft, or he may insist that, even after acceptance, the documents be retained until actual payment has been made. These alternatives are designated as documents against acceptance (d/a) or documents against payment (d/p). Which of the two methods are to be used will be indicated, not in the draft itself, but in the letter of instructions for the guidance of the collecting bank or banks.

In case documents are to be delivered only against payment, the draft calls for payment at, or sometime after, the expected time of arrival of the goods. The goods often, indeed usually, in the case of bulky, low-grade products, go forward by a slower

vessel than that on which the draft is sent. Hence, the draft arrives some days, or occasionally weeks or months, ahead of the goods. The importer is notified of the arrival of the draft. In case the goods arrive before the final date set for payment the buyer may pursue one of three courses: (1) If he has no immediate need for the goods, he may allow them to remain in storage until the maturity of the draft, at which time he will, in the regular course of events, pay the draft and receive the documents. (2) If, however, he desires to obtain possession or the goods at once, he may prepay the draft, *i. e.*, pay it before maturity. (3) If he does not have available funds to make this advance payment, he may persuade some banker in his community to advance the funds. In case he elects to follow the first course, he will have to pay the full amount of the draft which, of course, includes a charge for interest during the intervening time. If he prepays the draft or persuades a bank to do this for him, it is obvious that interest should not be charged to him. He is, therefore, allowed a rebate of interest in the form of a reduction from the amount specified in the draft itself. The rate at which interest is to be rebated should be stated in the drawer's letter of instructions to the collecting bank. [1] Very often a documentary payment draft is drawn for a long term upon an informal understanding that it is to be prepaid before maturity. The question then suggests itself: if the buyer wishes to obtain the goods before the final maturity of, say, a sixty-day draft, why should not the draft have been drawn for the shorter period in the first instance? What is the purpose of granting sixty days' credit if it is not going to be used? The reason, from the point of view of the importer, seems to be that this plan gives him greater freedom. He can prepay a long draft at his own convenience. A short draft must be paid at matu-

[1] This rebate rate for prepayment is in some countries a well-recognized though varying percentage of the total amount of the draft. If mentioned in the sales contract and letter of instructions to the collecting banks, it may be stated as a definite rate or in relation to some well-known rate as, for example, 1 per cent below the rediscount rate of the central bank of the drawee's country. In the case of a documentary draft used as the basis for a loan in the exporter's country, there is no necessary relation between the rate charged by the drawer's bank and the rebate rate allowed for prepayment. *Cf.* A. C. Whitaker, *Foreign Exchange*, pp. 119 ff.

rity, whether convenient or not. These questions arise, as far as delivery of the goods is concerned, only when documents are deliverable against payment (d/p). When documents are delivered against acceptance the only purpose of prepayment would be to "stop interest" on the draft. What we have said of prepayment by the drawee, applies with equal force to prepayment by his bank.

If the buyer solicits the assistance of his bank, the goods themselves may be made to serve as a collateral security for such an advance. This is accomplished through a trust receipt, whereby the buyer's bank retains title to the goods but lets them pass to the buyer to be stored, exhibited, sold, or manufactured. This is a device by which the aid of an additional intermediary (the buyer's bank) is enlisted to finance the transaction. But in this part of the transaction the seller has no interest. His demands were satisfied, his liability as drawer of the draft ceased, and the goods finally passed beyond his control, with the payment of the draft. Indeed, strictly speaking, the arrangement between the buyer and his bank, although it grows out of an international commercial transaction, is itself of only domestic concern.

It was noted above that the documents attached to a draft serve to protect the seller and to act as an aid in collection. They may further be made to serve as collateral security for financial aid by the seller's bank. In essence this aid takes two forms. The documentary draft may be used (1) as security for a *loan* to the exporter or (2) as security for a bank acceptance. The former method has been much more generally used in this country, the latter, however, is common in some foreign countries and is being urged as a superior method in this country.

If a documentary draft is offered as collateral the bank has two sources of protection: the drawer and the goods. A third possible guarantee, that of the promise of the drawee to honor the draft, it still absent. This should be borne in mind, for we shall presently come to a plan whereby that too is brought in to enhance the security of the draft.

A direct advance of funds by the bank on the security of the

documentary draft is variously referred to as purchasing the draft, discounting the draft, or making a loan. "Purchasing" implies a final closing of the transaction from the point of view of the seller. This is not the case. The drawer of the draft always remains the ultimate guarantor of the amount advanced. If the drawee fails to pay and if the consequent seizure and sale of the goods does not yield the amount advanced by the bank, recourse is to be had upon the drawer. "Discounting," although it refers to only one aspect of the transaction, is not open to serious objection, but really the relationship is one of lender and borrower. The drawer's signature on the draft establishes his complete responsibility; the documents relating to the goods are merely collateral and additional security. While, therefore, in accord with business terminology, we may use the three terms interchangeably, the true relationship should be recognized.

The bank, being requested to advance funds on the security of the draft, must decide to what extent it is willing to become involved in the transaction. (1) It may conclude that it will not advance the funds at all. In this event the draft is sent on for collection as described above. (2) It may be willing to advance only a part of the face of the draft, say, sixty or seventy-five per cent, agreeing to remit the remainder only after payment has been received from abroad. It may be willing to do this quite aside from the credit rating of the drawer, for it may be considered safe to advance that much merely on the value of the goods. (3) It may offer to "purchase" the documentary draft, *i. e.*, pay the exporter an amount in hand in full settlement of the bank's obligation. Even in this case the drawer still bears a contingent liability as guarantor of the draft. The amount offered may be designated as the price of the draft, or as the rate of exchange for this type of draft.

Factors Which Determine the Value of a Draft

In case a banker decides upon the last-named course the problem arises of determining the value of the draft. The amount which the bank will be willing to advance will depend upon the

standing of the seller and of the acceptor, the nature of the goods, the length of time for which the draft is to run, the currency in which the draft is drawn, and, of course, many factors in the bank's own business and in the state of the money market, which will determine the bank's desire to make loans of any kind.

Ordinarily, bankers will favor drafts accompanied by a lien upon the staple products, such as wheat and raw cotton, for there are continuous cash markets for these goods and a world price. This price can be easily ascertained at a moment's notice. In case of necessary seizure and sale, the full value represented can be obtained, barring a world-wide decline in the price. A shipment of sewing machines, on the other hand, while they may have been conservatively valued on the basis of a specific sale, would very likely bring a relatively small amount in a forced sale. Drafts drawn on the sale of goods, therefore, will be valued on this score, according to the banker's estimate of the possibility of disposing of the goods at their represented value.

The extent to which bankers are acquainted with specific types of goods also influences them. Thus bankers in a great cotton manufacturing center will more willingly finance a sale of cotton cloth than would bankers in another district, where drafts based on this product are rarely presented. This is one of the advantages of great central markets, either in the domestic or foreign trade. The bankers of the market center become well acquainted with one trade and are better able to discriminate between safe and unsafe ventures—not only as to the standing of the parties, but also as to the nature of the transaction itself.

Aside from the class of goods offered as collateral and the standing of the drawer as the ultimate guarantor of the draft, the bank will be influenced, in the case of a documentary acceptance draft, by the standing of the drawee, who will become the acceptor. The bank may wish to rediscount the accepted draft (now become a trade acceptance) in the foreign market. The possibility of so discounting the draft depends primarily upon the standing of the acceptor. The exporter's bank, therefore, although it

first looks to the standing of the drawer, is indirectly interested in the prospective acceptor as well.

One of the most important factors in determining the price of a draft is the length of time for which it is drawn, considered in connection with the prevailing interest rate for short-time loans. The draft is usually drawn for the gross amount due without any specific reference to interest. The seller presumably has made his price quotation high enough to include the interest as well as the value of the goods.

To illustrate, suppose an American seller is quoting a price in dollars and intends to draw upon the foreign buyer at ninety days. His computation of the price might be made as follows: value of the goods, $1,000; plus interest at five per cent for ninety days, $12.50; plus commission of bankers, $2.50; total, $1,015. Other items would be included, but these will serve for illustration. He would then draw a draft for $1,015. The banker will arrive at a price to be offered by a process which is the reverse of the one just described. From the face of the draft he will subtract the customary banker's commission and the interest on the amount of the draft for the time intervening before maturity at a rate depending upon the prevailing money rates in his own market. The rate of foreign exchange is a matter of no concern to him in this case. It is, of course, a matter of interest to the foreign drawee. All the banker has to consider is the security and the fact that he will be out of funds for ninety days (somewhat more than this on account of the time taken in making remittance).

If, on the other hand, the draft were drawn for £1,000, instead of $1,000, the banker would still have to make deductions on account of the time during which he would be out of funds, but the deductions would be made from the American value of £1,000 payable at once. Such a measure of the value of the foreign currency is found in the price of bankers' demand drafts or cable transfers. If, therefore, the value of a banker's demand draft for £1,000 were $4,860 the banker would deduct from this amount the prevailing rate of interest on this sum for ninety days and perhaps an additional amount as commission. Other considera-

tions, such as the nature of the transaction and the standing of the drawer, would, in fact, also influence the price. The computations just described illustrate only the effect of the time element.

It will have been observed that a most important consideration in fixing the price of a foreign currency draft is the prevailing rate of exchange. The factors influencing this were discussed in Chapter V. They will be only briefly restated here as viewed through the eyes of the banker. The balances which bankers maintain abroad, and against which they are able to draw their own drafts, are largely made up of amounts collected in the foreign country for them from the drawees of commercial drafts. The desire of a banker to buy a commercial draft will depend, in part, therefore, upon his desire to build up a foreign balance. For example, if a New York bank found that its London balance was getting low through the sale in New York of its own drafts on London, it would look more favorably upon a commercial draft drawn in pounds sterling than it would upon a draft in which all other features were similar but which was drawn in the currency of some country in which it did not keep a balance or in which its existing balance was already larger than necessary in view of the existing demands upon it. If, now, there is a steady and active demand from importers and others for bankers' bills on any country, the commercial drafts on that country will find a ready market with the banks. The commercial bills are the most important raw material which the banker feeds into his mill in order to produce his article of sale—the bank draft. The stronger the demand for the finished product, the keener will be the desire of the banks for the raw material and the higher the rate of exchange. This rate of exchange affects alike all drafts drawn in the same foreign currency. We have been primarily concerned in the preceding discussion with variations of value between different drafts upon the same country.

Since the prices of drafts depend upon the several factors mentioned, there would be some justification for saying that there is not one rate of exchange on a given day on, say, London, but that there are several rates—one for each class of drafts. This would

be very confusing, however, and we, therefore, take as the rate of exchange the price of cables or banker's demand drafts. We then find other rates falling below this standard rate according to the time element and other factors. For example, we find the prices of drafts on England, in dollars per pound sterling, on August 22, 1922 quoted as follows:

Cables	$4.48
Banker's demand drafts	4.47 3/4
Commercial 60 days	4.44
Commercial 90 days	4.43

This is a much abridged report and in fact there would be many other rates prevailing. The "commercial" rates quoted are for the very highest class of drafts of this kind. The prices of individual drafts are subjects for separate bargains. Some factors determining their value will be common to all exchange at the time; others will apply only to this class of drafts or perhaps even to one specific draft.

The Bank Acceptance

There is still another method by which the bank may assist the exporter in financing his sale of goods. The exporter, instead of asking the bank to buy his draft or to advance funds upon it, may ask the bank only to lend its credit. This may be accomplished by the bank's giving permission to the exporter to draw a time draft upon it which the bank agrees to "accept." The accepted draft is sold by the exporter on the open market. He thus obtains present funds, not from the bank, but from the buyer of the bank acceptance. The bank takes as security (1) the ordinary documentary draft upon the exporter's foreign customer and (2) the promise of the exporter to guarantee it against loss. This promise is set forth in an acceptance agreement signed by the exporter. Two drafts are involved: (1) the documentary draft upon the foreign importer and (2) the exporter's draft upon the bank. The former serves as security for the latter.

An illustration will help to make this clear. An American exporter has sold goods abroad for, say, £1,000. He draws a draft for ninety days upon the buyer and attaches the documents.

Approaching the banker, he may find that, although no question is raised as to the security, the bank does not wish to part with funds in this manner. It would, however, be willing to accept a draft drawn against it by the exporter for ninety days. Accepting the draft does not involve an actual withdrawal of funds from the bank, but the draft, having been accepted by a well known bank, will have a ready market and can thus be sold by the drawer on favorable terms. At the end of the ninety days, payment is made by the buyer of the goods on the original documentary draft and the accepting bank retains this payment to meet its own acceptance at maturity. The seller received his money at the time the goods were exported; the buyer paid at the end of ninety days; the accepting bank parted with no funds, it merely loaned its credit; the purchaser of the bank acceptance carried the finance burden. It is apparent that this method, which has long been used in England but only recently in the United States, depends fundamentally upon the existence of a market for the bank acceptance and that its advantage lies in the ability of the exporter to tap a larger supply of available funds than that supplied by his own bank.

Summary.—A summary of this chapter will serve to introduce us to the next phase of the subject. The finance burden is primarily the burden of waiting for payment. Closely connected with this burden, in practice, is the risk of nonpayment. The finance burden may be borne by producers, consumers, middlemen, or specialists such as bankers. The basic instrument in all international finance is the draft. The draft can be used as collateral security for a loan and thus the burden of waiting is shifted. From this point of view the simple draft is defective in that it has only one source of security to any holder, that of the legal obligation of the drawer to make restitution if the drawee fails to honor the draft. A second source of security is added by attaching to the draft, documents which carry title to the goods upon which the draft is based. A third possible security, the guarantee of the drawee, is still lacking. The next chapter will show how this too may be added.

CHAPTER XIV

FINANCING THROUGH THE BANK CREDIT

We have seen that the defects of the clean draft from the point of view of the seller and of the banker are mitigated by making the title to the goods serve as collateral security for the payment of the draft. This, however, is not a perfect remedy, because the value of the goods in the transaction between buyer and seller is nearly always greater than the value which could be realized on a forced sale of the goods in the event of default by the buyer. It now appears that it is possible to add to the security offered by the goods themselves and the obligation of the seller a third protection, namely, a guarantee that the drawee will honor the draft.

If the buyer were a large mercantile establishment, known the world over as an institution of unquestioned financial standing, it would be sufficient for it to give a written statement to the seller promising that any draft drawn upon it up to a certain maximum amount would be duly honored. Such a written statement would give confidence to the seller. He could safely proceed to manufacture the desired goods or prepare them for shipment. Further, having drawn upon the buyer and attached the documents, if he could display to the banks such a definite promise to honor the draft, signed by a party well known to the banks, it is clear that the salability of the draft would be much enhanced. In the past merchants have been known to issue such guarantees, but, on account of the increase in the number of foreign buyers and the displacing of the general importers by specialists, there are to-day comparatively few foreign buyers who hold such an enviable position as would give weight, the world over, to their mere promise to honor a draft. For not only must the seller place confidence in this promise, but, to

make the drafts salable, this promise must inspire confidence in bankers generally.

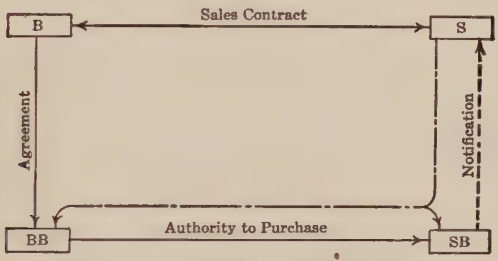
The Authority to Purchase

Because the buyer's own promise to honor the draft would not ordinarily be sufficient to inspire general confidence, the buyer may go to his bank, which is presumably acquainted with him and with the condition of his business, and persuade it to guarantee the acceptance and payment of the seller's drafts on the buyer. This willingness to handle and guarantee the payment of the draft is indicated by the buyer's bank in a letter to the seller's bank. This letter is known as an authority to purchase. It is commonly used in some trades, particularly in our trade with the Far East. It is discussed here not so much because of its own importance as because it serves to bridge the gap between the documentary draft and the letter of credit to be discussed presently.

Concerning the authority to purchase, it should be noted, first, that it is not a substitute for the documentary draft but is merely collateral to it. The draft is drawn in the manner previously described and the drawer assumes the obligations which ordinarily rest upon him. The authority is designed merely to increase the marketability of the draft. Second, the draft is still drawn upon the buyer of the goods as before. The foreign bank has merely agreed, as between itself and the seller's bank, that the draft will be honored. Now what obligations are created? Let us designate the buyer of the goods as B, the buyer's bank as BB, the seller of the goods as S, and his bank as SB. The issuance of the "authority" can be illustrated as on p. 231: the solid lines indicating legal obligations and the broken line indicating merely notification but no obligation. The dot and dash line indicates the contingent liability of the seller as drawer of the draft.

The buyer (B), in attempting to induce his bank (BB) to issue an authority to purchase, is in much the same position as though he were requesting a loan. His credit rating will,

of course, be considered, but also the nature of the transaction which it is desired to finance will be significant, for upon this, and especially upon the nature of the goods, will depend in part the security to BB, who will, in due course, receive the documents covering the goods. In addition the buyer signs a letter of guarantee addressed to BB wherein he agrees to accept the draft upon presentation and pay it at maturity. This guarantee fixes the obligation between the buyer and his bank. This obligation is not contingent upon the satisfactory performance by the seller (S) of the terms of the sales contract. If the goods shipped are not of the quality specified, or even if the bill of lading and other documents should prove to be fraudulent, B would



still be under obligation to BB to accept and pay the draft, although he would have recourse to legal action against S.

The authority to purchase, itself, refers only to the relations between the two banks, and usually it is made revocable by the issuing bank. The relation of SB to BB is that of agent and the funds are sometmes advanced from the balance of BB maintained with SB. It is clear, therefore, that the buyer (B) gains no rights against the foreign bank (SB) nor does the seller (S) gain any rights against the buyer's bank (BB). The seller's bank (SB) is not required to negotiate the draft or drafts; it is merely authorized to do so, and the buyer's bank has guaranteed their payment. The relations between the seller's bank (SB) and the seller (S) are established by a notification, in which SB indicates that it has been authorized by BB to purchase the drafts when properly drawn and accompanied by documents. This notifica-

tion is usually made effective to a certain future date, but the right is reserved to revoke it by notice at any earlier time. This notification is for the information of S and does not create a legal obligation between SB and S. Thus S is still liable as drawer of the draft as he would be in an ordinary bill of exchange and, therefore, if the buyer should fail to pay, the guaranteeing bank (BB) could demand restitution from the seller as drawer of the draft.

It is evident that an arrangement of this kind is, from the point of view of the seller, much more satisfactory than the unsupported documentary draft. (1) The buyer has agreed with his bank to honor the draft. While this is not a promise to the seller it reduces the chances of rejection of the goods. (2) A market has been provided for the seller's draft. This may be withdrawn upon notice and, in any event, the seller cannot legally insist upon purchase of his draft if this is refused by the notifying bank, but such a contingency would very rarely arise. On the other hand, this method has certain marked weaknesses. (1) In case of bankruptcy of the buyer and consequent inability to honor the draft at maturity, recourse will be had by the buyer's bank upon the seller as drawer. (2) The lack of a legal commitment on the part of the notifying bank to purchase the draft limits its general marketability. That is, in an attempt to sell the draft to anyone else in his own country the seller will not be greatly aided by the bank's notification to him. (3) The fact that the draft names a merchant as drawee impairs its value in the eyes of possible buyers, and this in spite of the fact that a bank has guaranteed its payment. The guarantee was to a specific bank, not to holders generally.

A Simple Type of Letter of Credit

This brings us to one of the most important methods of international financing by which these weaknesses are partially or wholly overcome. This is the letter of credit, an instrument which has long been in general use in the foreign commerce of other countries but which is just recently coming into extensive

use by Americans. The letter of credit, like the authority to purchase, is supplementary to the documentary draft.

There are many differences in detail between types of letters of credit, but they all have this in common: an authorization on the part of a bank addressed to a prospective drawer of a draft (called the beneficiary) to draw upon it (the bank), and a promise, stated or implied, that the draft will be honored. This promise is not conditional upon any future act of the real buyer of the goods. As far as the seller and any or all purchasers of the seller's draft are concerned it substitutes the credit of the bank for that of the buyer. A bank becomes the drawee of the draft. The letter of credit thus overcomes the chief weakness of the ordinary documentary draft, namely, uncertainty as to the ability or willingness of the drawee to honor the draft.

In a sale of goods the buyer always takes the initiative in obtaining the letter of credit; the seller is the beneficiary. A simple type may be described first. An American importer is negotiating for the purchase of a quantity of coffee from Brazil. He wishes to obtain the lowest possible price and, therefore, he wishes to provide an attractive method of payment. He goes to one of the large New York banks, with which he has established relations, and requests the bank to permit a draft to be drawn upon it for the purchase price of the coffee. Provided he can give satisfactory guarantees the bank may consent. The bank thereupon draws up a letter to the exporter in Brazil, authorizing the exporter to draw upon it for a stated amount and agreeing that drafts so drawn and accompanied by proper shipping documents will be honored. This letter is then sent forward by the bank to the Brazilian exporter, or it may be given to the importer, who will himself send it to the exporter. This letter is the letter of credit and the obligation assumed by the bank is called the bank credit.

The Brazilian exporter now prepares his goods for shipment, places them on the ship, and obtains the shipping and insurance documents. He then draws up a draft on the New York bank. With the draft and documents, supported by the letter of credit, he approaches his local banker, offering to sell the draft. As far

as security is concerned, it is an excellent purchase for the bank, and it will, therefore, sell at a relatively high price. The seller's financing expense thus is reduced to a minimum. Of course, the exporter, if he were not in immediate need of funds, might send the draft forward for collection, waiting for a return remittance from the New York bank. He would thus bear his own finance burden and would obtain the face value of his draft, less the small collection charge and the cost of exchange in making remittance from New York. More commonly, however, he will sell the draft. The Brazilian bank which has purchased the draft now sends it, together with the shipping documents, to the New York bank, which either remits the face of the draft to the Brazil bank or deposits the amount to its credit. The New York bank now has the documents and can either hold them until settlement is made by the importer or turn the goods over to the importer on his promise to make settlement at a later time. In thus releasing the goods a trust receipt would be employed, whereby the bank would retain title to the goods. At any rate, the foreign buyer and the foreign bank are out of the transaction and it now becomes a domestic affair between the New York bank and its customer.

The relationships set up in this transaction can be summarized as follows: the buyer places himself under obligation to his bank; the buyer's bank assumes an obligation to the seller; the seller transfers his right against the bank to his local bank; the seller's bank collects from the buyer's bank; the buyer's bank collects from the buyer.

The buyer's obligation to his bank is expressed in the application for a letter of credit and the subsequent agreement. In these documents he agrees, in consideration of the issuance of a letter of credit: (1) to provide sufficient funds for the payment of the draft or drafts one day before their maturity; (2) that the title to goods shipped in connection with the transaction shall be vested in the bank until payment of the drafts; (3) to provide additional security upon demand, in case the value of the goods declines below an amount sufficient to cover all outlays by the

bank; and (4) that the bank shall not be responsible for the quality or quantity of goods shipped nor for the shipper's failure otherwise to fulfill the terms of the sales agreement.

This last clause, taken in connection with the first, greatly restricts the buyer's rights to cancel or reject goods, even though there be legitimate reasons for so doing. As far as his ability to protect himself is concerned he is in the position of one who has sent cash with order. This is a serious deficiency from the point of view of the buyer. Furthermore, it is not a weakness which can be remedied without impairing the value of the letter of credit. If the banks should admit the right of the buyer to refuse payment and return the goods for any reason whatever, they would have to make their promises to honor the drafts conditional on the actions of the buyer. But this limitation would take away the power of the letter of credit to make the draft readily salable. The very nature and virtue of a letter of credit is that it is an unconditional promise of a bank. The bank's obligation being unconditional the buyer's obligation to the bank, upon the strength of which the bank issued the credit, must likewise be unconditional.

We have assumed for the sake of simplicity that the draft upon the bank was drawn at sight and was paid by it either by remitting to the purchasing bank or by transferring funds to its account. As a matter of fact, under the circumstances described, a long bill, *i. e.*, a draft payable some time after sight or after date, would probably have been authorized and drawn. Suppose then that the terms of the draft were four months. When the draft was presented to the bank which opened the credit it would have been "accepted." This would be sufficient to justify delivery of the documents to it. The documents could then be turned over to the importer as described above. The accepted draft could be sold according to directions from the purchasing bank. This would put the purchasing bank in funds, and the credit opening bank would not have to pay until maturity, by which time the exporter would be expected to place the bank in sufficient funds to meet the draft.

If the purchasing bank followed this course, it would have to accept a sum less than the face of the draft, and the amount of this reduction would depend upon the time remaining before its maturity and upon the prevailing money rate in the market of the acceptor. If this rate were low the amount it would receive for the draft would be greater than if a high rate prevailed. Thus, we see another factor which will influence banks to discriminate between drafts according to the country on which they are drawn. The purchasing bank might, on the other hand, direct its correspondent to hold the draft for it until maturity, thus earning the interest upon it. This is called an investment in exchange. Ordinarily, however, the former practice will be followed. The seller accepts an amount smaller than the face of the draft for the sake of immediate funds from his bank; his bank likewise accepts less than the face of the draft; the purchaser of the acceptance receives the face amount, for upon him rests the burden of waiting.

An example of a letter of credit such as might have been used in the transaction just described is given below. It is a common type in connection with American imports.

DOLLAR IMPORT LETTER OF CREDIT [1]

Credit No. 890,524
For $17,000—*U. S. C.*
Messrs. Guarani Mendoza & Co.,
Santos, Brazil.

GUARANTY TRUST COMPANY OF NEW YORK
Foreign Department
NEW YORK, January 3, 1924.

Gentlemen:

At the request and for the account of *James Williams & Co., New York*, we hereby authorize you to value on

GUARANTY TRUST COMPANY OF NEW YORK, NEW YORK

by your drafts at *90* (*ninety*) *days sight* for any sum or sums not exceeding a total of *Seventeen thousand dollars United States Currency*, accompanied by commercial invoice, consular invoice, bills of lading representing *Cost and Freight* shipment of *1000* (*One thousand*) *bags Coffee during January, 1924, from Santos, Brazil, to New York.* Insurance *is covered by the buyers.*

[1] Specimens of letters of credit used by courtesy of the Guaranty Trust Company of New York.

Bills of lading for such shipments must be drawn to the order of THE GUARANTY TRUST COMPANY OF NEW YORK and dated not later than *January 31, 1924.*

A COPY OF THE CONSULAR INVOICE AND ONE BILL OF LADING MUST BE SENT BY THE BANK OR BANKER NEGOTIATING DRAFTS, DIRECT TO THE GUARANTY TRUST COMPANY OF NEW YORK, NEW YORK.

THE AMOUNT OF EACH DRAFT NEGOTIATED MUST BE INDORSED HEREON.

All drafts drawn under this Credit should bear the clause "drawn under G. T. Co. of N. Y. Letter of Credit, No. *890,524* dated New York, *January 3, 1924*, to cover shipment of *Coffee* from Santos to New York.

We hereby agree with bona fide holders that all drafts drawn by virtue of this Credit, and in accordance with the above stipulated terms, shall meet with due honor upon presentation at the GUARANTY TRUST COMPANY OF NEW YORK, NEW YORK, if drawn and negotiated on or before *February 2, 1924.*

GUARANTY TRUST COMPANY OF NEW YORK

.....

.....

A factor which makes this letter of credit attractive to the beneficiary is the fact that it is irrevocable. This is implied in the statement that drafts will meet with honor "if drawn and negotiated on or before February 2, 1924." The most common practice in this country is to issue irrevocable credits in financing imports, and some banks will issue no other kind. This is probably to protect the reputation of the issuing bank, which would suffer by revoking a credit upon which the beneficiary was relying. On the other hand, it restricts the freedom of the buyer in cancelling his order.

THE LETTER OF CREDIT ISSUED IN THE EXPORTER'S COUNTRY

In the above letter of credit authority was given to a specified beneficiary to draw upon the buyer's bank and the drafts were to be drawn in the currency of the buyer's country. It frequently happens that this arrangement is unsatisfactory. In the first place, the currency of the buyer's country may be subject to wide and uncertain fluctuations, which would make the seller un-

willing to use it as the basis for his price quotation. Second, it may be that there is little demand in the seller's country for drafts drawn in the buyer's currency.

It was noted above that in buying drafts a bank obtains funds in the country upon which the drafts are drawn. These funds are desired because the bank can sell its own drafts against them. If, now, there be little or no demand for bank drafts upon a certain country, the banks will not care to buy commercial drafts upon that country. Under either of these conditions, therefore, it may be desirable to have drafts drawn in a currency other than the buyer's, possibly that of the seller.

If it is desired to use the seller's currency, the buyer requests his bank to issue a letter of credit authorizing drafts, not upon itself, as in the previous illustration, but upon a bank in the seller's country. This brings in an additional party, the seller's bank, which we may call the paying bank as distinguished from the opening bank in the buyer's country.

The relations between the buyer and his bank are the same as in the preceding case. The obligation of the opening bank is to its correspondent, the paying bank, and also to the seller. If the opening bank is comparatively unknown in the seller's country a credit issued by a local bank might carry greater weight and thus facilitate the marketing of the draft. In this event the opening bank may request its correspondent to confirm the letter of credit. Unless special arrangement is made for confirmation, the correspondent bank will merely notify the beneficiary that a credit has been opened in his favor by the buyer's bank, and it will itself assume no legal responsibility. The distinction has been noted above between a revocable and an irrevocable credit. It is clear that a correspondent bank would never confirm a revocable credit.

An example of a letter of credit drawn in the seller's currency and confirmed by a bank in the seller's country is given below. Such a letter of credit is frequently used in connection with American exports. In the transaction which gave rise to this document an American firm (the American Flour Export Company)

was the seller and a foreign firm (Omar of Constantinople) was the buyer. That is, from the point of view of this country, it was an export transaction, whereas the preceding illustration was of an import transaction.

IRREVOCABLE EXPORT CREDIT

GUARANTY TRUST COMPANY OF NEW YORK

140 Broadway

NEW YORK, January 3, 1924.

To *American Flour Export Company,*

Kansas City,

Mo.

In replying please refer to
EXPORT CREDIT No. *C924769*

Dear Sirs:

In accordance with *cable* instructions from *The Bank of the Golden Horn, Constantinople, Turkey,* we have established an irrevocable credit in your favor for account of *Omar, Constantinople,* for $15,900.00 (*Fifteen thousand, nine hundred....Dollars*) available by your drafts at sight on us, accompanied by shipping documents of a character which must meet with our approval, consisting of:

Commercial invoices

Consular invoices if such documents are required in connection with this shipment.

Marine and War Risk Insurance policies with particular average 3% each 10 sacks.

Full set of on board ocean steamer Bills of Lading *made out to the order of the Bank of the Golden Horn, Constantinople,* evidencing shipment of 4800 sacks of AMFLEX brand flour at $5.30 per 100 Kilos, shipment during January and/or February, 1924, from any Atlantic port c. i. f. Constantinople.

The Credit expires March 7, 1924.

If you are unable to comply with the terms as indicated above, please communicate with us promptly.

Yours very truly,

N. B. Whenever possible, the documents should be presented in time to be forwarded on the steamer carrying the merchandise.

It will be noted: (1) that this is a letter of credit issued by a bank in the seller's country, (2) that it is issued upon the request of the buyer's bank, (3) that it authorizes drafts upon the seller's bank, (4) that the drafts are to be drawn in the seller's currency, and (5) that the draft is irrevocable but that it expires upon a stated date. Had the seller's bank desired to restrict its liability and act merely as an intermediary between the foreign bank and the domestic seller it might have used in lieu of "we open an irrevocable credit" some such expression as "we are informed that you will draw upon us" and the further statement that "this letter is for your guidance and conveys no engagment on the part of this bank as we have no instructions to confirm the credit." There is a great variety of practice concerning confirmation of the credits issued to American exporters.[1]

We have now distinguished two types of letters of credit: (1) a credit issued by the buyer's bank direct to the seller authorizing the beneficiary to draw upon it in the buyer's currency, (2) a credit issued by the seller's bank, upon the request of the buyer's bank, authorizing a draft in the seller's currency. Both letters of credit used for illustration are commonly termed "dollar credits." The former is further described in this country as an "import credit," the latter as an "export credit." A third type of credit will now be noted.

The Letter of Credit Issued in a Third Country

In this third type the buyer's bank requests a bank in a third country to issue a letter of credit to the seller, drafts to be drawn in the currency of the third country. In practice this third country is usually England and the monetary unit is the pound sterling. This method, which was almost universal in American foreign trade until a few years ago, may be illustrated by the following transaction:

An American importer has arranged for a purchase of tea from China. Because of the general use of the pound sterling in inter-

[1] For an authoritative report on customary procedure in issuing letters of credit in this country, see Federal Reserve Bulletin, February, 1921.

national trade, prices are arranged in that currency, and payment is to be made under a letter of credit issued by an approved London bank. The American importer now proceeds to his bank requesting its assistance in financing the transaction. This may be accomplished by the New York bank's issuing a letter of credit not on itself but on a London bank. This document is mailed or cabled to the beneficiary. If it is desired to give the beneficiary additional assurance that his drafts will be honored, the London bank may be requested to confirm the credit. This will be done by another document sent by the London bank to the beneficiary.

The exporter now prepares his goods for shipment and presents the draft drawn upon the London bank, together with the documents, to some bank of his own country for discount. This purchasing bank detaches the original bill of lading and sends it forward to the New York bank by whom it can be turned over to the buyer upon arrangements made between the bank and buyer. The draft, together with a duplicate bill of lading, is sent to London for presentation to the drawee bank. This copy of the bill of lading is only for record and to serve as evidence that the shipment was made. It does not give additional security to the London bank, which must rely upon the New York bank or upon collateral advanced by it prior to the issuing of the credit. The draft, which runs, say, for ninety days after sight, is accepted by the London bank. It has now become a bank acceptance, an unconditional promise of the bank to pay upon maturity.

The buying bank in China may order the acceptance to be sold. On account of the excellent security it will bring a very favorable price. The buyer may be a bank or any business institution which wishes to invest money for a short time. Two weeks before maturity the American importer pays to his bank an amount in dollars sufficient to enable the bank to remit the amount of the draft to the London bank. This remittance in pounds sterling arrives in London by the time the draft falls due and enables the London bank to pay the draft without drawing at all upon its own funds.

American exports as well as imports have been and, to a less

extent, still are financed in this way. It will make it easier to generalize from this illustration if we designate the parties in a manner which will be applicable to other transactions. We have six essential parties involved, and they are mentioned here in the order in which they come into the transaction. They are: (1) the buyer, (2) the opening bank, *i. e.*, the bank which issues the letter of credit (in the above case this is the New York bank), (3) the seller, (4) the negotiating bank, *i. e.*, the bank which first advances funds on the draft (in this case the Chinese bank), (5) the paying bank upon which the draft is drawn (in this case the London bank), (6) the purchaser of the accepted draft.

Who assumed the risk burden in this transaction? Three risks may be distinguished, first, those connected with the quality and quantity of goods as specified in the sales contract. This risk is borne very largely by the buyer. At least when he has caused a letter of credit to be issued he is estopped from withholding payment or canceling the order even though very good reasons might exist for so doing. Second, there is the risk of nonpayment by the buyer, for example in case of his insolvency. This risk is assumed by the opening bank which must in any event reimburse the paying bank. Third, there is the risk of fluctuations in the exchange rates. The risk of a rise in the price of sterling exchange in the buyer's country is borne by the buyer who must pay a specified number of pounds. The risk of a decline in the value of pounds in the seller's country is borne by the seller.

Who bore the finance burden? The seller received his money upon shipping the goods. The Chinese bank is out of funds by the transaction while the draft is en route to London, but as soon as it arrives there it is accepted and sold, and the Chinese bank is credited with the proceeds.[1] The buyer, on the other hand, does not pay until a short time prior to the maturity of the draft, by which time he has presumably received the goods. The New

[1] The purchasing bank may, however, avoid this loss of the use of its funds by selling its own bank drafts upon London in anticipation of the addition to its London balance through the previous transaction. The original draft, which it has purchased and which will augment its London balance, goes forward at least as soon as its own drafts sold to Chinese importers, which will reduce that balance.

York bank has advanced no money. It is clear that the finance burden rests upon the unknown holder of the accepted draft in London. He is rewarded by the higher value of the draft at maturity than at the time he purchased it. One of the important advantages of this type of letter of credit is the ready market for accepted drafts in London.

The advantages and the disadvantages of the commercial letter of credit can now be briefly summarized. From the point of view of the seller of goods the letter of credit has much to recommend it. Certainty of payment is secured because a bank, often one of his own country, promises to honor a draft upon itself. The risk of cancellation or of disputes concerning terms of payment are eliminated. From the point of view of security of payment it is as desirable as cash with the order. Likewise, the burden of waiting for payment is either removed or greatly reduced. In case the credit authorizes drafts at sight upon a bank of his own country, the seller can obtain payment in full as soon as his goods are ready for shipment. In case the drafts are to run for some time he will have to submit to a discount for immediate payment, but the discount will be less than it would be upon an unsupported draft. From the point of view of the buyer the case is not so clear. An important advantage is that, since the letter of credit is attractive to the seller, its use will enable the buyer to get favorable terms as to price. But the responsibility for the finance function rests entirely upon him. True he shifts it to the banks, but the expense and inconvenience of so doing is borne entirely by him. With the ordinary documentary draft it is unnecessary for the buyer to bestir himself until the draft and documents are presented to him. Further, the letter of credit limits his freedom of action as to cancellation of an order. Impartially viewed, this may be desirable, but it is not an advantage to the buyer. From the point of view of the effective working of the credit system, the method seems desirable. By supplying the guarantee of a bank, it makes drafts generally acceptable and, therefore, makes it possible to draw upon many sources of funds which would not otherwise be available and at rates which are relatively low.

London's Position in the Financial System

In the use of the type of letter of credit last described we saw that the London acceptance market played an important part. But the use of this market by foreigners is not confined to drafts drawn under letters of credit.

A foreign exporter may draw upon an American importer by a documentary draft, unsupported by a letter of credit. This draft may be payable with a banker's draft upon London at, say, ninety days, or with an amount in dollars sufficient to buy such a sterling draft. The sterling draft offered in payment is sent to London, where it is accepted by the drawee bank and then sold as a banker's acceptance. By these and other arrangements the pound sterling and the London discount market are utilized in transactions which do not involve Englishmen directly.

Certain reasons for the prominent position held by London and the English monetary unit in international trade have been noted from time to time in the preceding discussion. They may be recapitulated here. Bankers the world over are, as a rule, willing to purchase drafts on London, because there is a steady and active demand for their own drafts upon London. They, therefore, find it profitable to maintain deposits with the London banks, against which they can draw their own bank drafts. These balances are built up and maintained by buying commercial drafts on London as rapidly as they sell their own drafts upon London. Now this demand for bank drafts arises from the desire to make payments to London. This desire is explained by several factors, the most important of which are: (a) Imports from England must be paid for. English goods go to all parts of the world and result in return payments from all countries. (b) Interest payments to England cause a further demand for London drafts. England has long been the world's capitalist, and its investments are widely distributed. These call each year for a flow of funds to England. (c) Freight payments from all parts of the world cause a further demand for drafts on London. English ships carry freight, not only between England and foreign countries,

but also between foreign countries themselves. (d) The custom once having been established of using London as an international clearing house, that custom itself creates a steady demand for drafts on London. This factor seems to indicate that an international financial center tends to perpetuate itself, *i. e.*, it serves well because it is generally recognized as the center. This should not be emphasized too much.

The first three factors are no doubt fundamental, but, other things being equal, the existing center will continue to act as such. Aside from the steady demand for sterling exchange, explained in part by the above factors, bankers are predisposed in favor of drafts on London, because they know that in case of time drafts they will be able to relieve themselves of the finance burden by selling the accepted draft on the London market and that at a favorable rate. The advantage of this was indicated in the preceding illustration. This large and active discount market is fundamentally due to the large supply of liquid funds in London and to the low interest rate prevailing there. That is, it is due to the fact that the supply of capital funds is great in proportion to the demand for them and hence the interest rate is low and the demand for safe investment is active. Further, English banks have been willing to accept longer term drafts drawn against them than have the bankers of some other countries.

Dollar Exchange

These factors making for the continuance of London's position must be borne in mind in connection with the probability of dollar exchange, *i. e.* drafts drawn in dollars, displacing sterling exchange in trade between other countries or even in our own trade.

During, and since, the war there has come a marked change in this respect. Our trade with many parts of the world, which before the war was almost universally settled through London, is now settled directly. In part this has been due to changes in our laws, first, making it legal for national banks to accept long time drafts drawn against themselves and, second, providing in the Federal Reserve system a means whereby accepted drafts bought

by banks as temporary investments can be rediscounted. Further, a larger part of American imports now move to this country directly from the countries of origin instead of through London. While this does not necessarily require a modification of the methods of finance, the change from pounds to dollars is encouraged by the change in channels of trade. These factors, legal and economic, have no doubt facilitated the development of dollar exchange, and, in so far as they are responsible, we can expect a continuance of the tendency under normal conditions.

There have been, however, other favoring factors, incident to the abnormal conditions existing since 1914. Our export trade has greatly increased; our imports of raw materials have likewise increased; and both of these have come at a time when American merchants could insist upon a method of payment agreeable to them. On account of wide fluctuations in exchange rates it has been desirable to reduce the number of exchange operations to a minimum. Our government loans created large credits in dollars, against which the foreign countries could draw. The fact that some of these factors are presumably only temporary, indicates that predictions of the future of dollar exchange must be made very cautiously. When the European countries get back to something like normal trade and we again have to meet active competition from their exporters, the buyers of goods will again be able to exercise a choice of means of payment. This choice will naturally be determined by the economy of the various methods.

One further method of finance should be noted—accepting the long-time obligations of the buyer in payment for goods sold. Such a practice is feasible only with some classes of goods and buyers. A manufacturer of hydraulic machinery might, in a large transaction, accept the bonds, stocks, or notes of a water-power company. This amounts to an extension of credit, perhaps for several years. Presumably the manufacturer does not care to invest his capital in this way to any great extent. He takes the securities offered in payment with the expectation of

reselling them at once. The possibility of using this method of finance is dependent upon the existence of a market for such securities. This method is, therefore, a form of foreign investment and as such it will be discussed in a succeeding chapter.

CHAPTER XV

FOREIGN INVESTMENTS AND FOREIGN TRADE

In this chapter we shall examine the relation between loans of capital and the export and import of goods. That there is a close relationship between them, nearly everyone will agree, although the causes of that relationship may be a source of argument. The foreign trade of England, better than that of any other country, illustrates the interdependence of investment and trade. American manufacturers have often observed that their English and German competitors have enjoyed a great advantage in the dependence of foreign buyers upon the capital of those countries.

How do the foreign investments of a country aid the exporters of that country? In answering this question two groups of factors will be recognized. The first are those factors having to do with the individual business relationships of exporters and importers on the one hand, and lenders and borrowers of capital on the other. The second factor, or group of factors, has to do with the theory of international trade and particularly the theory of the balance of trade. The factors of the former group are of a more obvious nature, but it is believed that those of the latter group are more fundamental and, in the long run, more important.

Business Relations Between Investors and Exporters

The most obvious relation between investment and trade is to be found in those transactions in which bonds or stocks are taken in payment for goods. This may occur in a sale of equipment for railways or other corporate enterprises. Perhaps a Chinese railroad company desires locomotives, rails, and other capital goods. Not having the ready funds for payment, it issues

bonds and presents them to the manufacturer of equipment in direct payment for the goods desired. The bonds are then sold by the manufacturer to banks or other financial middlemen, who, in turn, dispose of them to investors. Or the manufacturing company may itself hold the securities, thus becoming a shareholder or a creditor, as the case may be, of the Chinese railroad. In this case the investing of capital makes possible the sale of goods. Much of the American lending during the war and the immediate post-war period was of this type. The loans made by our government to the powers associated with it in the war were in the form of credits established in this country, against which the borrowers could draw for purchases here.

Again, it sometimes happens that an intercorporate relationship exists between large investment institutions and manufacturing companies of the investing country. In this event a South American public utility company, wishing to dispose of a new issue of bonds, may find that one of the conditions placed upon the purchase of the bonds is that the borrower, in spending the proceeds of the loan, shall give preference to the manufacturers associated with the lending institution. With the growing tendency toward interlocking directorates and other forms of intercorporate relationships, this influence is becoming more and more effective.

Or it may be that the control of a railway or other public utility in a new country is held in one of the investing countries. There are many instances of extensive enterprises in India, South America, and Canada whose headquarters are in London. In such cases the directorate of a company may see to it that, so far as is possible, purchases of equipment and materials are made in the home country. Particularly is this true when such intercorporate relationships as described above exist between the purchasing company and the equipment or supply company. It is very easy, however, to exaggerate the importance of this influence, and to conclude too quickly that English-owned railroads favor English supply companies because of their nationality. Usually when such favoritism appears it arises from purely eco-

nomic considerations. There have been cases wherein the directors of railroads have despaired of making profits from the railroad business and have, therefore, resolved to make what profit they could from sales of material and equipment to the road. Ordinarily, however, the directors, being responsible to the shareholders and desiring to show the largest possible dividends, consider it good business policy to buy in the cheapest market, disregarding the nationality of the seller.

There is another way by which circumstances play into the hands of the manufacturers who are of the same nationality as the investors. English investors in a foreign railroad are likely to prefer, and perhaps to insist that English engineers and operating officers be placed in charge of the enterprise. This may not be due to a sentimental desire to favor these fellow citizens, but merely to the greater confidence which business men are likely to have in engineers of their own acquaintance. But, whatever the reason for their appointment, English engineers, being accustomed to English equipment and supplies, are likely to specify these types in making purchases. Even if orders are placed on the basis of competitive bids, the English manufacturers will likely be able to give a lower price on English types of cars and locomotives than will an American manufacturer. Manufacturers of American equipment have at times complained of this handicap.

Occasionally a government may interfere with the free flow of investments with a view to guaranteeing the expenditure of at least a part of the funds in its own country. French policy furnishes an example of this. The French government has long maintained a supervision over the flotation of new securities on the Paris Bourse. Often this regulatory power is used for political ends, particularly when the borrower is another government, but permission to list the securities is sometimes made contingent upon an agreement of the borrower to utilize a specified proportion of the new capital in the purchase of French goods. Where government authority is used in this way, it is clear that the subscription of capital funds stimulates trade. Such regulations, however, are frequently evaded by floating the securities on some

other market and selling them to the investors by an indirect method.

Besides any such specific influences as these, it is often true that the mere investing of large sums of money in a country establishes business connections there, creates a mutual feeling of good will, and thus smooths the way for trade. Thus in certain backward countries, through the influences of German banks and merchants, the German language has come to be a common commercial medium, and German acquaintances and contacts have served to prepare the way for the salesmen from the Fatherland.

Economic Relation of Investments and Trade

Most of these considerations, however, can be easily exaggerated. They will be ineffective in the face of any marked advantage in price or quality of goods offered by an outsider. We turn, therefore, to the second group of factors noted above. First, we must recall the principle set forth in a preceding chapter, that international payments must, in the long run, be made in goods or services. This holds for capital investments as well as for indemnities or any other form of international payments. Therefore, it must follow that the lending of a given sum of money abroad can be accomplished only by exporting goods or services in return for a promise of repayment at a future date, or by refraining from accepting imports of goods or services, which would otherwise have come to the investing country. The latter possibility will be considered presently. For the moment we assume that imports are unaffected by a loan, as might very well be the case.

The export of goods may follow directly from the loan of capital, as in the instances mentioned above, or it may take a more indirect course. Let us assume that American investors lend $500,000,000 to Argentine railroad companies. These funds may conceivably be spent entirely in England. According to the theory of the balance of trade this expenditure would normally induce Englishmen to purchase an equivalent amount of goods abroad. But the foreign country, from which England makes its purchases,

must likewise purchase goods of an equal value abroad. The United States is the only country which could sell $500,000,000 worth of goods without importing an approximately equal amount, for in its case only is the export of goods offset by the import of securities, *i. e.*, by a loan.

We may view the above transaction in a slightly different way. The immediate effect of the loan was to give the borrowers a control over $500,000,000 of purchasing power *in the United States*. The borrowers, or others of their own country, may use this purchasing power themselves in buying goods from us, or they may dispose of it to some other country, which in turn buys from us. That this purchasing power ultimately will be spent here, we need have no doubt, for it is American purchasing power and is valued only because it can be used here.

Another aspect of the same line of causation is found in the effect of the loan upon the rate of exchange. The conclusion of the loan gives the borrowers a right to draw drafts upon the lenders in the United States. These drafts constitute an increased supply of dollar exchange in foreign countries without a corresponding demand immediately existing for it. This new relation of supply and demand lowers the price of American exchange abroad and thus encourages purchases here. Now normally, the price of exchange upon any country is closely connected in all the financial centers of the world through the activities of exchange dealers and, therefore, a decline of the American exchange rate in Buenos Aires will have a corresponding effect in all other places where American exchange is bought and sold. Therefore, not only is there an added stimulus to Argentinian purchases in the United States, but this stimulus extends also to all other trading countries.

It is very often impossible to trace a direct and immediate relationship, but that relationship is none the less real. We do know that over a period of time there is a very accurate correspondence between the placing of loans and other items on the debit side of the international trade balance and merchandise exports and other items on the credit side. It will be re-

called from our discussion of the history of the balance of trade that during the early period of our national existence we borrowed large sums from England and that the material aspect of this borrowing was the excess of imports over exports. This illustrates the operation of the principle from the point of view of the borrower.

Some of the more simple ways by which the balance between one country and the remainder of the world may be maintained are illustrated below. The international balance of a country might be maintained through exports and imports alone, thus:

Debit	*Credit*
Imports $500,000	Exports $500,000

Now, other factors remaining undisturbed, assume that this country makes a loan to foreigners of $500,000. We have:

Debit	*Credit*
Imports $500,000	Exports $500,000
Loan 500,000	
$1,000,000	$500,000

This is an impossible situation. It may be righted by an increase of exports. We designate these increased exports as "new exports," *i. e.*, exports induced by the loan. The new trade situation appears as follows:

CASE I

Debit	*Credit*
Imports $500,000	Old Exports $500,000
Loan 500,000	New Exports 500,000
$1,000,000	$1,000,000

Or the balance may righted by reducing imports, thus:

CASE II

Debit	*Credit*
Imports $ 0	Old Exports $500.000
Loan 500,000	New Exports 0
$500,000	$500,000

Or the result might be attained by both reducing imports and increasing exports, thus:

CASE III

Debit		*Credit*	
Imports	$250,000	Old Exports	$500,000
Loan	500,000	New Exports	250,000
	$750,000		$750,000

The preceding discussion assumed that imports remained unaffected by loans. It appears from Case II and Case III that the loan might be balanced, in whole or in part, by reduced imports as well as by increased exports. In this, as in all other questions connected with the balance of trade, it is the relationship between exports and imports that is important. Lending tends to give a country a "favorable balance of trade," *i. e.*, an excess of exports over imports. Such a relation may, of course, be brought about by an increase of the one or a decrease of the other.

We have treated loans as a cause and the merchandise balance of trade as a result. This view of the relationship is the significant one for our present purpose, but the relationship could with equal propriety have been reversed. Not only is it true that "exports follow the investment" but it is equally true that investments follow exports. Stated otherwise, our lending *enables* us to make larger exports in proportion to our imports, but also, our lending *requires* us to make larger exports in proportion to our imports. An individual becomes a creditor by producing more than he consumes. Likewise a country becomes a creditor by producing more for the foreign market than it receives from the foreign market.

Of the two groups of factors, which explain the close relationship between loans and exports, those having to do with the balance of trade are more universally applicable. The effects of the two kinds of factors are different in that those of the first group tend to make exports flow to those countries to which the loans are made. The principle of the balance of trade, on the other hand, does not contribute to such a result. It merely forces

a correspondence between loans to all countries and exports to all countries.

It is fortunate that the wide development of international commerce and finance makes possible an indirect rather than a direct relation between loans and exports. Otherwise a country could only loan capital to those countries which happened to desire the specific goods and services which it could offer and which it could offer on more advantageous terms than could other exporting countries. As it is, we can lend capital funds to Argentina, although the goods which we can most advantageously export, and which foreigners can most advantageously purchase here, may be wheat for the people of Europe and cotton for the mills of England. Argentina, if it thinks best, can spend the borrowed funds in Germany or in England, while we can export to Germany and England the goods required to offset the loan. The goods which will be exported under these conditions will presumably be those lower in price here than elsewhere. Such goods are those in which our labor is most effectively employed. Since our excess of exports can be greater when we export goods in which we have a natural advantage, it follows that the amount of capital which we can loan on this basis of free expenditure of borrowed funds is larger than it could be, if it were arbitrarily required that money borrowed here be spent here. The recognition of this principle is of immense importance, not only for a sound understanding of the theory of trade, but for the shaping of wise governmental polices.

This discussion of loans and exports indicates the immediate effect of lending upon trade. But a loan implies a return, first, of interest and, ultimately, of the principal loaned. These involve payments in the opposite direction from that represented in the loan itself and will, therefore, have exactly opposite effects upon trade. The creditor country placed its loan by exporting goods in excess of its imports. The debtor will pay its annual interest by a similar method, and if the debtor ever repays the principal, that repayment will have exactly the same effect on trade as a foreign loan by that country. Adopting the point

of view of the creditor, receipt of interest and return of the principal induces an excess of imports, popularly known as an unfavorable balance of trade. Following any specific loan through its whole life and disregarding other capital movements in the opposite direction, we can say that the making of the loan favors an excess of exports; receiving interest favors a smaller but continuing excess of imports; return of the principal results in an excess of imports.

Effects upon the Industry of the Investing Country

In England, where foreign investments have absorbed such a large part of the total capital accumulations, there has arisen a popular complaint that this investing of capital abroad has reduced home employment of labor, and demands have been made for discriminating taxes for discouraging this practice. Occasionally such views are expressed in this country although the marked lack of purchasing power abroad for buying our goods during and since the war has furnished a temporary, but very obvious, answer. But the really fundamental objection to these views goes deeper and is not dependent upon the immediate embarrassment of our customers.

It is apparent from the preceding discussion that the foreign investment itself, leading, as it does, either directly to the export of goods or to a reduction of imports, would not adversely affect the home employment of labor. A loan of $1,000,000 is made to a Japanese cotton manufacturing company for the building and equipping of a new factory. The merchandise side of this transaction is the export of goods, perhaps looms and other equipment, in the manufacture of which American labor is employed. The loan has thus acted as an immediate stimulus to business here.

But, it may be argued, the cotton mill so built gives employment to Japanese workers rather to Americans. How much better it would have been to have invested the capital here, for then Americans would have been employed, not only in the production of the machinery, but also in the spinning of cotton.

This argument appears to involve two errors, first, the assumption that an increased number of cotton mills in the country would give additional employment to American labor and, second, that a larger supply of capital for home investment would result in the construction of new cotton mills. The first is analogous to the argument that exports reduce unemployment, which was considered in Chapter IV. All the laborers of a country will normally be employed, whatever the type of industries existing in that country, and when some of them are out of work it is due to a disarrangement of the industrial system, not to an insufficient number of industries. If, indeed, there should be an unusual demand for capital for starting economically justifiable industries, the capital will be forthcoming, for there is always a preference among investors for home investments if the rate of interest is at all comparable to that to be obtained elsewhere. As to the second point, the building of new industries rests upon a number of factors, of which an available supply of capital is only one. In fact it happens that at those times when home labor is out of work interest rates are commonly low, and capital funds are to be had in abundance. That these funds are not employed in new enterprises indicates that the real cause of the unemployment is not a dearth of capital funds. It appears, therefore, that a rise in the home interest rate relative to that abroad can safely be trusted to prevent any undue diversion of a country's capital to foreign fields.

A further objection to the foreign investment of capital is made on the ground that an excess of imports must ultimately come into existence to pay interest upon the capital invested abroad. But this effect of foreign investments can, with greater propriety, be viewed as an advantage than as a disadvantage to the lending country. While these imports may conceivably cause such keen competition in some lines that the further continuation of home industry in those lines becomes impossible, the demand for home products in general will remain as great as before, for the excess of imports coming into the country corresponds to the interest payments due to capitalists in the home country. A hy-

pothetical illustration will assist in clarifying this point. American capitalists have invested twenty million dollars in Chinese railroads at five per cent. Assume now that in any year there are no other capital transactions taking place. The Chinese railroads are called upon to pay one million dollars interest to the American capitalists. The debtors, therefore, demand dollar exchange for that amount. The rate for these dollar drafts will, therefore, rise. A rise in the value of dollars and a corresponding decline in the value of foreign money will encourage exports to the United States, and this encouragement will continue until the exports to us exceed the purchases from us by approximately one million dollars. These exports to us will bring into existence drafts to the value of one million dollars drawn upon American importers. These drafts, or their equivalent in bankers' drafts, which rest upon them, are purchased by the Chinese railroads and sent to the American capitalists, who now have one million dollars more of purchasing power than they would have had otherwise. This increased purchasing power is just equal to the excess of imports brought in on account of interest payments. This sum may conceivably be used to purchase these specific imports, but in any event it is clear that the purchasing power of Americans has been increased by one million dollars and, therefore, additional foreign goods can be purchased to that amount without affecting the volume of American goods demanded.

Of course, there is no reason for thinking that the imports in question will come from China. By the operation of the system of international exchange China might export one million dollars worth of goods to England, which in turn might send one million dollars of its own products to us. This does not, however, affect the essential point, that the interest payments result in a purchase by Americans of one million dollars of goods *in excess* of their normal purchases, not in place of American-made goods which would otherwise have been purchased.

A recognition of this principle is very important at the present time. Much fallacious reasoning on the probable effects of payment of the principal and interest of the European debts in-

volves a disregard of the true relation between international payments and the transfer of goods. The principle can be graphically summarized in the statement that, in such a payment, the foreign country sends not only goods but the purchasing power with which to buy the goods. Suppose that the American people spend annually fifty billion dollars upon American goods and services. Now comes a payment of one-half billion dollars from foreign governments accompanied by one-half billion dollars worth of goods from foreign producers. Does the purchase of these goods reduce the American demand for American goods to forty nine and one-half billion dollars? No, Americans still demand fifty billion dollars worth of American goods and *in addition* one half billion dollars worth of foreign goods. In the case under consideration the result would be brought about in this way: The payments from the foreign government would go to our government treasury. Taxes could be reduced by the extent of the foreign payments. This leaves in the pockets of American consumers one-half billion dollars more than they would have had if the foreign payments had not been made. American purchases are increased by that amount, and these increased purchases just suffice to take the foreign goods off the market. The principle can be broadly stated: Any increase of imports into a country, as a result of payments due to that country, does not diminish the effective demand of that country for its own goods, but rather it increases the effective demand for goods in general by an amount just equal to the foreign payments by which the imports were occasioned.

It must be admitted that imports, brought into a country as a result of interest payments due to it, may injure the domestic producers of the specific goods so imported. But, if these home industries become less profitable, others must become more profitable, because the total demand for home products has not diminished. Such imports may, therefore, result in a readjustment of home industry. But even this result may easily be exaggerated, for the imported goods are those which the domestic consumers and industries most need. It is not correct, as is some-

times assumed, that the goods accompanying such international payments are those of the foreigner's choice. Quite the contrary. Goods are shipped in connection with these payments, because the country receiving the payment comes into possession of foreign purchasing power. The receiving country exercises this power by purchasing goods which it wants, not merely the goods which the foreigner prefers to send.

In practice, the countries making loans and receiving interest are usually industrial countries; and, therefore, the imports which are induced by the interest payments are likely to be either raw materials, which result in a stimulation of home industries using these materials, or foodstuffs, which, by reducing the prices of these products to the industrial workers, increase their real wages.

These imports may, therefore, be very advantageous to the exporting industries, in supplying them with raw materials and meeting the requirements of their workers. The mere fact that imports have increased *relative* to the exports, does not mean that exports have decreased. Too much emphasis can easily be placed upon the relation of one to the other. A country may very well export more goods when it is receiving interest payments and other items, which give it an "unfavorable" trade balance, than when it is paying interest or making loans and, therefore, has a "favorable" balance. In fact, in the history of capital-lending countries this has, almost universally, been the case.

Another objection sometimes made to a manufacturing country investing abroad is that the investments so made enable the foreign country to produce for itself those very things which it had previously purchased from the investing country. Particularly is this argument applied to investments in manufacturing plants in such countries as India and China. But every foreign country must be viewed in two ways. First, as a customer and second, as a competitor. Too much emphasis is frequently placed upon the second aspect to the neglect of the first. Everything which develops the producing power of China makes that country more prosperous and, therefore, creates a better market for American goods. Strange as it may seem, this is apparently

true, even if the foreign industries so built up are of the same general class as those which predominate in the investing country. Thus the United States, as it has developed toward an industrial status, has no doubt competed with English manufacturers for the trade of nonindustrial countries, and in that sense the English capital, so freely invested here in the past, could be said to have worked to the detriment of English exporters. But a far more important result, from the point of view of the volume of English trade, has been the ever-increasing purchasing power of Americans and the consequent increase of English exports to us. The United States is one of England's best markets and the sale of English goods here has increased tremendously with the industrialization of this country.

Through the experience of recent years, Americans are coming to see that their prosperity as exporters depends fundamentally upon the prosperity of other countries, which we have been prone to consider only as competitors. There is, among the countries of the world, such a variety of capacities, natural resources, wage levels, and other conditions that we may rest assured that an interchange of products between these countries will continue, and that, in fact, it will be fostered by a dissemination of knowledge concerning industrial methods and by an unfettered distribution of the world's supply of capital according to the need for that capital as indicated by the interest rate offered.

We can distinguish, then, three advantages which a country gains from foreign investments. First, its exports are stimulated by the very process of making a loan. Second, its imports are increased by the inflow of interest payments, and thus raw materials for its manufacturing industries become more plentiful and the imported consumption goods are more easily obtained. This cheapening of imports results in a higher standard of living without a corresponding increase in the cost of manufacturing. Third, the investing country shares with all others in the lower cost of production brought about in the borrowing countries, and in the increased prosperity and purchasing power effected by the investment of capital in developing their resources.

The Relation of Governments to Foreign Investments

It is inevitable that the governments of the investing and borrowing countries should be involved in one way or another, and either directly or indirectly, in foreign investments. Governments, and particularly the governments of the investing countries, are concerned in foreign investments in two ways: first, as agencies for encouraging and directing foreign investments and, second, in their obligation to protect the foreign interests of the investors. These two aspects of the question are, of course, closely allied, for the chief encouragement which a government can give to its capitalists is the promise, expressed or implied, to use the force or persuasion of the government to protect the interests of those capitalists.

A government may, however, encourage foreign investment by specific suggestions made to the banking interests of its own country. The motive of the government, in offering such unusual encouragement, may be merely to stimulate the export trade in general. With such a purpose in mind an organization such as the United States Department of Commerce might well attempt to educate the American people to foreign investments.

On the other hand, the motive of the government may be, in part at least, political. For example, if the foreign policy of any power aims at hegemony in a particular region it might well be that encouragement, and even pressure, would be brought to bear upon investment institutions to provide the capital for the development of those regions. The interest of the government would be not only to encourage the development of these regions, but even more to bring about a dependence of the people, and perhaps of the governments involved, upon its own capital rather than upon the capital of some other power. This policy of encouraging foreign investments in particular regions is implicit in the economic penetration and the securing of spheres of influence, which has been characteristic of the relations of the industrial countries to the countries of Africa and Asia.

As to the other aspect of this question, *i. e.*, the obligation of

the home government to protect the rights of its citizens in their foreign property, there is some disagreement as to the proper policy to be followed. Two extreme views are taken in this country. First, there are those who argue that the American investor, when he places his capital in a backward country, is fully aware of the risks which he incurs and that these risks, in the ordinary course of affairs, are offset by the higher rate of interest. It is contended, therefore, that no obligation to look after the safety of such investments, even from depredations or from governmental confiscation, devolves upon the investor's government. While this is at first sight a plausible view, its adoption in practice would materially check the investment of capital abroad, to the detriment of both the investing and the borrowing countries, and further, as long as other creditor countries follow a different policy, it would, if adopted by any one country, place its investors under a serious handicap.

At the other extreme are those who argue that our government should quite freely intervene for the protection of the property of its nationals invested abroad and, futhermore, that the government should be especially active in protecting such interests when the property in question lies in a region in which the home government has especial interests. Those who hold this view apparently would say that in the case of a request from an American citizen for protection of his property or interests abroad, two questions should be asked: (1) Has our government any political ambitions in the region involved? and (2) Has the citizen any rights in the dispute? According to this view our efforts should go much further if both questions are answered affirmatively than if only the second.[1]

The former view, that of complete noninterference, does not seem to be practical. Nothing is to be gained by holding blindly to a theory that all governments are equal. There is, in fact, a great difference between investing capital in a part of the British Empire and in investing it in some small republic in which govern-

[1] For an expression of this general attitude see Mr. Huntington Wilson, *Annals of American Academy of Political and Social Science*, November, 1916.

ments are constantly tottering. Regardless of any theory of sovereignty which may be held, foreign interference is almost unavoidable in the latter case. On the other hand, it seems that the latter policy, which makes the political ambitions of the investing country a factor in the question, is as dangerous to fair dealing and international peace as the former is impracticable. In an effort to avoid this dilemma, proposals have been made that the several investing countries join with the borrowing country to form international commissions for the supervision and protection of investments in those regions in which outside interference appears to be needed.[1] This plan has the merit of recognizing that economically backward countries need foreign capital, that it is desirable for them to provide conditions favorable to foreign investments, and that outside capitalists will not invest their funds unless some guarantee other than that of the borrower's government be given for the safety of their property. At the same time, it recognizes that interference by any single government is likely to be made an excuse for the furtherance of the political ambitions of the investing country. It is true that an international supervision does not entirely remove this latter possibility, but it does appear to diminish the dangers of national interference.

The spirit in which such supervision is undertaken is, of course, more important than the method employed. In this connection we should try to free ourselves of the notion that the investment of capital is of benefit only to the investor or even solely to the investor and the borrower. We should all be interested in insuring a free flow of capital from the sources of its accumulation to the fields for its employment. Only in this way will the accumulated wealth of the world be employed in the most effective manner.

[1] *Cf.* H. C. Adams, "International Supervision over Foreign Investments," *American Economic Review*, Supplement, March, 1920.

CHAPTER XVI

INTERNATIONAL CREDITOR AND DEBTOR POSITIONS

The purpose of this chapter is to describe a normal cycle of debtor and creditor stages through which countries tend to pass in their industrial development, to illustrate this by the history of a few of the great countries, and to attempt to discover the present position of the United States in this cycle.

There is a preference among capitalists for investments within their own countries. While this preference is becoming less and less pronounced as the parts of the world become more closely bound together by rapid transportation and communication and by the growth of commerce, it nevertheless still persists. For foreign investments to be made, therefore, this preference must be overcome by some very strong inducement. The most important of the inducements which lead to foreign investments is the rate of interest—more particularly, a higher rate of interest obtainable in foreign lands than in the investor's own country. There are other factors which may be very important in certain cases, but this factor is of more universal application that any other. There is, in fact, and in spite of the natural preference for home investments, a considerable fund of capital which flows from some parts of the world to others, attracted by profitable interest rates.

The interest rate is ordinarily a fair index of the productivity of capital. If there is in a country a very limited amount of capital, only the most promising industries will be supplied and even the least profitable industry to obtain capital will be able to pay a high price for it. On the other hand, other countries will have a large supply of capital relative to the opportunities for employing it; and, therefore, resort must be had to less and less productive enterprises, or the industries which were originally very profitable will be worked so intensively that the return

upon the capital will decline to a low level. Thus, the influence of the interest rate is to effect a distribution of the world's accumulated supply of capital among the several countries in such proportions that it will be most productively employed.

The accumulation of great capital funds is largely the result of modern industrial methods and of the social organization which has grown up with the industrial system. The modern industrial methods produce the wealth and the unequal distribution of that wealth, which is so often and, from some points of view, properly criticised, favors the saving and accumulation of that wealth rather than its immediate consumption. The modern industrial methods likewise create a demand for capital because of the profitable opportunities which they afford for its employment. The industrial and social systems of the countries of European civilization thus create a large supply of capital; they also induce a large demand for it. It might seem, therefore, that an industrial country, having both a large capacity for producing capital and an intense demand for it, would never find it desirable to send its capital abroad for investment. But the relative supply of the capital and the intensity of demand for it varies in the course of a country's development. In the early stages of industrial development the demand for capital is great. The capital is highly productive and its use results in the accumulation of more capital. As time goes on, although the amount of capital employed becomes larger and larger, the accumulation proceeds at an even more rapid rate, and, hence, those countries which themselves employ the largest amount of capital have surplus funds which can be loaned to other countries in a less advanced stage of development. These changes in the relative supply of and demand for capital are reflected in the interest rate, and it is this which guides the individual investor.

A Cycle of Investments

As a result of these changes in interest rates, reflecting changes in the conditions of supply of and demand for capital, it is possible to lay down a line of development as to creditor and

debtor relations through which, on *a priori* grounds, we should expect countries to pass as they become industrialized. What we conceive to be a normal line of development includes five stages, which will be taken up individually. The discussion will be facilitated if we take the case of a nonindustrial country which borrows foreign capital to enable it to develop its young industries. We shall then follow this country through the various stages in its industrial development.

The Borrowing Period.—A "new" country, *i. e.*, a country new in industrial development, although perhaps old in civilization, will have need of capital. The supply of the other factors, land and natural resources and perhaps labor, will be large in proportion to the supply of capital. As a result every bit of capital which can be employed can be placed in highly productive uses. The rate of interest will, therefore, be high—higher probably than in the older industrial countries, in which the supply of capital is greater. If the difference in interest rates is great enough, funds will be attracted from the "old" countries. This constitutes the borrowing stage. As has been explained in preceding chapters, such a transfer of funds has an effect on the merchandise trade of the countries involved. This lending of funds by the "old" countries to the "new" countries leads, therefore, to an export merchandise balance for the former and an import balance for the latter countries. The borrowing period is then a period of "unfavorable" balance, imports exceeding exports. These imports may be of those specific capital goods, machinery, equipment, and the like, which are needed to start the "new" country on its industrial career; or they may be consumption goods which maintain the workers of the borrowing country while they produce the desired capital goods for themselves. The nature of the imports bears no necessary relation to the particular industries in which the capital is invested.

This borrowing stage must, of necessity, come to an end sooner or later because interest must be paid upon the capital invested. In any year interest is due, not only upon the capital invested in that year, but also upon all capital invested in the past. It,

therefore, must come about that the payments by the "new" country on account of interest finally exceed the payments to the country on account of new loans. This will be clear if we think of the analogous case of an individual who borrows every year one hundred dollars at five per cent interest. At the end of twenty years his payments on account of interest would exceed his receipts on the loans. Practically, this same result would be attained sooner or later even if the loans became larger each year. The annual interest payments are cumulative; the annual loans are not. There will be a tendency, therefore, for the excess of receipts of new capital over outward payments to diminish and finally to give way to an excess of outward payments and, hence, to a "favorable" merchandise balance.

The Interest-Paying Period.—When interest payments come to exceed new borrowing the country will have entered upon its second stage. In this period borrowing may, in fact, be larger than in the preceding one, but interest payments are still larger, and thus they constitute the dominant characteristic of this period. If the borrowed funds have been used in wars or in other nonproductive ways, the country may not advance out of this interest-paying stage. Exports to pay interest will exceed imports and the standard of living of the people of the country will become progressively lower. But if the borrowed capital goes to build up the transportation lines, and helps to develop the producing capacities of the country two results will follow: (1) the volume of goods produced will become much larger and thus the country will be enabled to export a part of its produce in payment of interest due on the past loans without unduly impoverishing itself or crippling its industries, and (2) because of the newly developed capacity of the country to produce and save, it will be able to supply a larger part of its own capital. This new capital, together with the borrowed capital, tends to lower the rate of interest. When and if this decline in interest rates proceeds far enough, foreign investors will no longer consider the difference between this rate and that obtainable in their own countries sufficient to justify foreign investment of their

funds. At this point new loans will cease but interest payments on the old loans will continue. The trade balance, therefore, leaving aside non-capital items, will be definitely "favorable."

The Period of Repayment.—Any further tendency for the interest rates in the "new" and the "old" countries to approach one another will lead to a repurchase of the securities issued in the past, *i. e.*, to a repayment of the loans. This repayment, like interest payments, encourages a "favorable" balance. This buying back of the home securities will normally precede foreign loans made by the new country because of the preference which investors show for investments in their own country. When the foreign-held securities have been largely repurchased we can say that the international balance of indebtedness is again even, and in a sense the cycle should end here. But there is no reason for assuming that the tendency for the supply of capital to increase within the country will cease at this point. Rather, the increase in capital is likely to continue, and, now that all savings are invested at home, they should normally have a more pronounced effect upon the rate of interest.

The Investing Period.—The progressive accumulation of capital, which made it possible to repay the foreign loans, will, if continued, sooner or later force a lower return upon capital within the country itself, and thus a lower interest rate will be established than prevails in other less-developed countries. This greater return to be obtained abroad leads to the foreign investment of part of the country's new capital. This foreign investment of capital is represented on the side of merchandise trade by a "favorable" balance. Paying interest and making loans have the same effect on the trade balance.

How long it will take for a country to reach the condition of depressed interest rates, which induces foreign loans, depends, of course, upon the supply of and demand for capital within the country itself. A country with large area and large natural resources can find profitable employment for its accumulating capital within its own borders for a long time, while a small country will quickly reach a saturation point. Again, a marked

advance in the state of the arts, such a change as that from hand power to steam or from steam to electricity, may create such a demand for new capital to put the new methods into effect that interest rates will for a time be maintained in the industrial countries. But these new methods of production also make it possible to bring into existence an ever-increasing supply of capital, so that the only thing which could prevent an ultimate decline of interest within the industrial countries, relative to the rates abroad, would be constant and rapid progress in devising new uses for capital. As soon as this rapid progress abates there will be a tendency for capital to flow from the industrial countries to the relatively undeveloped parts of the world.

The Interest-Receiving Period.—The investing period is likely to be relatively short. It must come to an end for the same reason that the borrowing period had to end, *i. e.*, because the accumulating investments abroad call for ever-increasing interest payments, which sooner or later will become larger than new loans. When this stage arrives payments received will exceed payments made, and merchandise imports will exceed merchandise exports. Loans may continue to be made, in fact they will probably be larger than in preceding stages because there is a tendency to invest interest receipts, but the loans will no longer dominate the situation. This is the final stage for, while all the others lead naturally to other stages, this one can continue indefinitely.

The country which we have been following has thus passed through a complete cycle, which began with borrowing and ended with lending. While from this point of view its position has, in the course of time, been reversed, its trade balance has come back to its first type, an excess of imports.

These stages of development may be set forth as follows:

	Capital Transactions	Trade Balance
First Period	Borrowing	Excess of imports
Second "	Interest paying	Excess of exports
Third "	Repayment of debt	Excess of exports
Fourth "	Lending	Excess of exports
Fifth "	Interest receiving	Excess of imports

Several serious qualifications must be made to these generalizations. First, it is quite possible that a country will start its industrial development with a sufficient supply of capital to make it unnecessary to draw upon older countries. In this event the first three stages would be omitted. We would expect this to be true of some of the older countries themselves in their early development. It is less likely to-day that a country, young in industrial development, would rely upon its own sources of capital, for the supply of capital in the industrial countries is great and the mechanism for transferring it is highly developed. Second, when a country has reached a point in its industrial development at which it can supply its own capital, it does not necessarily follow that it will proceed to the next stage. The nature of modern industry creates a presumption in favor of this supposition, but many other factors may enter to bring about an arrested development. It appears, then, that there is much greater assurance concerning some of these transitions than others. The borrowing stage must be followed by the interest-paying stage, and the lending stage must give way to the interest-receiving stage, but we cannot be so sure that the interest-paying stage will be succeeded by a period of repayment or that this period will give way to the investment period. Third, the rate at which a country will evolve through these stages cannot be predicted. The rate of its evolution will depend upon the supply of its natural resources, the initiative and intelligence of its people and their habits of thrift, its institutions, political and social, its freedom from wars and other disturbances, and no doubt upon many other factors. Fourth, a country may be set back or advanced in this line of evolution by war or some other abnormal disturbance. A country in the final interest-receiving stage may, as a result of an expensive war, be set back to the first stage. On the other hand, a country which is in the interest-paying stage may, by such circumstances, be advanced quickly to the capital-exporting stage and perhaps to the final interest-receiving stage. If, however, the national equipment and the industrial and commercial organization of the nations

remain essentially undisturbed, such changes in status may be only temporary. Finally, so far as the effects of these changes in debtor and creditor positions upon trade balances are concerned, it must be remembered that there are several other invisible exports and imports, such as shipping earnings payable or receivable, tourist expenses, immigrant remittances, and transfers of gold. We have considered merely the effect of capital movements upon merchandise balances.

Historical Illustrations

A line of development, similar in its broad aspects to that described above, is discernible in the history of the chief industrial countries. England started upon its development toward its modern position at a time when capital was relatively more plentiful at Amsterdam and certain other continental centers than in England itself. During the seventeenth century large sums, according to the standards of those days, were loaned by the Dutch for internal improvements in England, and until the end of the seventeenth century England had an "unfavorable" balance of trade, such as would be expected in a developing country borrowing capital from foreigners. During the eighteenth century this foreign borrowing proceeded despite the rapid accumulation of wealth in England itself. It was estimated that in 1762 some £18,000,000 of foreign capital was invested in England. This large foreign investment was induced by the fact that the interest rate in Holland, which was the source of most of the borrowed funds, was commonly much lower than in England. During the eighteenth century, however, interest payments on the previously invested capital apparently exceeded the new loans to England, for the "unfavorable" balance characteristic of a borrowing period gave way to a "favorable" balance. The excess of exports progressively increased, especially during the Napoleonic wars, and enabled England, first, to cancel its foreign debt and, second, to lend its own capital abroad. In many ways the experience of England during these disturbances on the continent was analogous to our own ex-

perience in the recent war. Following the Napoleonic wars, England's favorable balance continued, and her foreign investments correspondingly increased. By 1840 the interest flowing back from these accumulated investments and the earnings of British shipping combined to create inflowing payments in excess of annual investments. This change marked the end of the investment period proper and the beginning of the interest-receiving period. On the trade side this new condition resulted in an excess of imports, which has continued to the present time.

In the case of France and Germany we do not have a complete cycle, because these countries have not drawn upon outside countries to any great extent for capital for their industrial development. While the capital investment in both countries has been greatly augmented in the past two hundred years most of it has been produced at home. English capital was invested in railroads in both France and Germany, but these investments were largely offset by loans from these countries to foreign governments. As a result, we have only the latter phases of the cycle represented in the economic history of these countries. France had an export balance of trade from 1716 to 1860 with the single exception of the period of the Napoleonic wars when its balance was "unfavorable." From 1861 to about 1870 exports and imports were almost equal. From 1872 to 1875 there was an export balance to be explained, no doubt, by indemnity payments to Germany. From 1876 to the present France has been in the final or interest-receiving stage with imports exceeding exports.

Germany had from the beginning of the last century up to 1885 a slightly favorable balance of trade, with certain exceptions. Beginning about 1885 and continuing to the present time Germany's imports have exceeded her exports. This import balance is largely explained by inflowing interest in excess of loans, although in the pre-war years shipping earnings helped to swell this import balance. It should be noted, in the case of each of these European countries, that new foreign investments grew progressively up to 1914, although in none of them were these

new investments large enough to offset the payments flowing back.

In the case of the United States the capital-borrowing period was long, extending from the establishment of our government, and probably even from colonial times, to 1873, with but two short interruptions. The volume of borrowing was especially large after the Civil War. The borrowed capital of this period went largely into railroads, many of which were almost entirely financed abroad. It is almost certain that this borrowing proceeded at a more rapid rate after 1873 than before, but by that time interest payments came to exceed the new investments and our "unfavorable" balance turned to an excess of exports over imports, which has continued to the present time.

It will be recalled that there are three successive stages which are marked by a favorable merchandise balance; the stage of interest payments, the stage of repayment of debts, and the lending stage. The whole period, 1873 to 1914, was marked principally by interest payments, that is to say, we remained in the first of these three phases. There was a short period in the early nineties when American securities were purchased from European holders. This, however, was due to temporary factors, notably the fact that foreign investors were frightened by our industrial depression and by our free money movement, and American securities soon flowed back to Europe after the darkest part of our depression was past. Apparently the American supply of capital was not yet great enough to make it profitable to dispense with European aid. Again after 1899 American securities, especially railroad stocks and bonds, were repurchased from Europe in large volume, but after 1907 European capital again flowed into the country. As a net result of this ebb and flow of securities it has been estimated that the indebtedness of the United States to Europe in 1914 was greater than in 1899. In short, by 1914 we had not truly entered upon the stage of repayment of our debts and certainly not upon the phase of foreign investing.

The long time during which we remained in the borrowing and interest-paying stages is in sharp contrast to the time required to

pass through the repayment period. This period lasted, roughly, from 1914 to 1917. This progress was made possible by two factors, both incident to the war: first, the widespread desire of European capitalists to dispose of their American securities, which prompted them to offer these obligations at favorable prices, and second, the large export trade balance which enabled the country to buy back these securities. This favorable balance increased from about one-half billion dollars in the immediate pre-war years to three and one-half billion dollars in 1917. About 1917 we entered upon the investment stage proper. Since then the large export balances have been attended by foreign loans, until to-day the net investment abroad is probably about twelve or thirteen billion dollars. Since 1919 the export balance of trade, by which the loans were made possible, has declined. In the year ending June 30, 1923, the excess of exports was the smallest for any fiscal year since 1896.

The Creditor Position of the United States

The United States has thus passed through the first three of the stages outlined above and has definitely entered the fourth stage. Is it likely to enter the fifth, the interest-receiving stage, in the immediate future? It is impossible to answer this question categorically. If further investments are not made on any considerable scale and if payments are made upon the large government loans we will enter that stage. But, even so, the import balance which usually accompanies interest receipts might be offset by other factors as suggested in Chapter VI. On the other hand, if our investments continue they would cause a "favorable" balance for some time but would make the ultimate "unfavorable" balance larger and more certain. There are many reasons for thinking that we are not likely to increase our creditor balance greatly in the near future. A few of these will be suggested.[1]

The existence of our present creditor position does not argue

[1] For a more extended discussion of this question by the present writer, *Cf.* "The Nature of our Creditor Position," *Journal of Political Economy*, August, 1923.

for a continuance along this line, for it was brought about by very unusual circumstances. Most of the loans made in recent years were advanced by our government and for reasons which were not economic. That is, we did not enter the creditor stage as a result of those slowly developing factors discussed above, but as a result of political and military necessity. Further, we were enabled to maintain the export balances, which formed the merchandise side of these capital movements, partly by the fact that the prices of the goods which we exported during the war period were greatly increased over their previous levels and over the prices of the goods which we bought.

The United States has a tremendous capacity for capital accumulation, but it also has great opportunities for the use of such capital. It is very doubtful if we have reached such a stage that any considerable part of our capital will flow abroad in search of more profitable fields. England, on the other hand, and some of the other European countries, are likely to recover from their present difficulties sufficiently to accumulate capital much as they did before the war. Such an accumulation, for England at least, would necessarily result in foreign investments. Before the war a very large part, perhaps one-half, of English capital accumulation was invested annually in foreign countries. Even at the present time, despite the very high taxes and other post-war difficulties, the London investment market is absorbing a larger volume of foreign bonds than is the New York market.[1]

If in the future, as in the past, the demand for capital relative to the supply of it is greater in the United States than in England, the "new" borrowing countries will turn to England for their funds and not to the United States. If this does, in fact, prove to be the case, it would not be a cause for regret. The best interests of the country as well as of the individual investors are best served by having capital invested where it can yield the best return—be that at home or abroad.

[1] *Cf.* Federal Reserve Agent at New York, *Monthly Review*, August, 1923.

CHAPTER XVII

THE RISK ELEMENT

All economic activity is pervaded by uncertainty. The burden of bearing this uncertainty rests in some degree upon all true entrepreneurs. It is an essential part of the entrepreneur's function and is one of the principal justifications of profits, the reward of the entrepreneur. We have referred to this risk-bearing function in a preceding chapter as an incidental function to distinguish it from the primary functions of buying and selling and of physical distribution of goods. The distinction is not intended to belittle the importance of this function; it merely indicates that the primary functions have to do directly with accomplishing the transfer of goods from producers to consumers, while the risk function and the finance function exist as necessary incidents to the performance of the other functions.

The Nature and Forms of Risk

Risk may be defined as the possibility of loss arising from some unforeseen event or series of events in the future. Uncertainty is the very essence of risk and, therefore, whenever certainty can be substituted for uncertainty risk disappears. As we proceed we shall see that just as business men are willing to pay certain specialists for assuming the transportation function, the selling function, or the finance function, so they are often glad to pay a definite sum for being relieved of an indefinite chance of loss. That is, the assumption of the risk burden, like the performance of other marketing functions, may be separated from the general marketing task and be performed by specialists. This transfer of the burden is often desirable; it is an application of the general principle of division of labor. The specialized assumption of the risk function, however, can never be

carried quite as far as can the transference of the other functions. Some residual risk must always rest upon the shoulders of the independent business man as a necessary consequence of his engaging in business.

Economic risks have always existed, even under the simple economic conditions existing before the development of modern capitalistic industry. Under that simple economic system which prevailed in Europe during the Middle Ages there were alternating periods of abundance and famine, and there was often an oversupply of certain goods in one part of western Europe and famine in other parts even at the same time. These wide differences existing between places were more marked than they are at present. To-day there may be world shortages of grain, but, within the limits of our economic world, they are comparatively rare, and their effects are diffused over all countries. Barring such unusual conditions as arise out of war, we rarely see among the industrial countries famine and plenty coexisting. These crude forms of risks have been largely eliminated by the activities of traders, who depend for their profits upon buying in the cheapest markets and selling in the dear markets and buying at a time of abundance and selling at a time of scarcity. It is not correct, therefore, to say that economic risk has been created by the modern system of specialized industry and trade. The risks of waste of goods on the one hand and hardship arising from a scarcity of goods on the other, were much greater in the past than they are in the present. They were primarily producers' and consumers' risks. These have been minimized by the modern business system.

Modern business, however, has brought risks of its own. Sale of goods to the ultimate consumer is now only the final step of a long series of processes of production and distribution, and in the time required for this roundabout production there are many opportunities for errors of business judgment, which did not exist when production was simple and direct and when the market was small and near at hand. We have, in a sense, built up a great and complicated machine for production and distribution, but we

have not completely mastered the principles of its operation. Periods of prosperity are succeeded by periods of depression, prices in general rise and fall, the production of classes of goods which should be closely correlated get out of line, and all of these lead to uncertainty in business. A difference between the present and the past is that these are now primarily business risks instead of consumers' risks. As the system of specialization and coöperation between specialists has spread beyond national lines to the far places of the world, the possibilities of maladjustments in business have increased. It is sometimes said that a development of international commerce tends to stabilize business. This may ultimately be true, but for the present there is much to be said for the opposite view. As producers and consumers come to be more widely separated geographically, and as a longer time intervenes between production and consumption, the possibilities of maladjustment of supply and demand appear to increase.

There are two classes of risk in trade: first, risk of loss or damage to the physical goods handled or the equipment used and, second, risks of a business nature. In the latter class are the risks of adverse price change, and the risk of bad faith or fraud on the part of those with whom business is carried on.

Goods shipped from the place of their production to the place of consumption are in constant danger of entire or partial loss, This possibility of physical damage is a burden both to the individual owner of the goods and to the community at large, which is, of course, interested in the preservation of all economic goods and which would suffer indirectly from any diminution in the supply of such goods. The risk of physical damage to goods, then, does not grow out of the private ownership of economic goods. Anything which can be done to minimize the chances of loss of this type is of general interest, and all those activities of government designed to prevent losses of this type are eminently justified.

Risks of the second class are generally considered to be matters of interest only to the business men involved, and the prevention or minimizing of such losses, in fact, constitutes a

major task of the individual business man. The business man of sound judgment will succeed in avoiding many losses due to business judgment, while the incompetent business man will suffer so many of these losses that sooner or later he will drop out of his position of responsibility and make way for others whose judgments will be more often right than wrong. But even in this class of risks the community does have an interest. Consider, for example, the risk of adverse price change, the most prominent of risks of this class. The sale of goods at a price lower than the cost of producing and distributing them is in itself a matter of indifference to the community. One set of individuals have gained while others have lost. But it does indicate that there has been an undesirable use of the available productive factors. For, to say that goods sell for less than their cost of production, is equivalent to saying that the buying community places a higher value for other purposes upon the elements which went into the production of the goods than it does upon the goods themselves. From the point of view of the individual business man, the risk is that there may be an adverse relationship of prices of production goods and finished product. From the point of view of the community, the risk is that there may be an unwise use of production goods, which is merely indicated by the relative prices referred to. Nothing would be gained for the community at large, therefore, by arresting the fluctuations in price by government regulation or the activities of associations of producers. Something may be done, however, by these common agencies in obtaining and diffusing information concerning the supply and demand of specific goods, thereby enabling business men to regulate their production, purchases, and sales in a more rational manner.

A risk very similar to the one just discussed is that the producer may be unable to find buyers for his goods at any price. Most of what has been said concerning the risk of price change is applicable here. The risk again arises from imperfect business judgment and, like the previous risk, it rests primarily upon the individual producer, although the community also has an interest in minimizing this risk. At times the inability of the producer to

sell his goods may be due, not to lack of a demand for them, but to a failure of the distributing system to bring buyer and seller together. The self-interest of traders, who make a living by bringing together possible buyers and sellers, is the best guarantee that risks arising from this cause will be reduced to a minimum. It is a field, however, in which the government and commercial associations can and do render important aid. Efforts of the government in this respect can best be confined to setting standards and diffusing information as a basis for action by buyers and sellers. Thus one of the functions of the Bureau of Foreign and Domestic Commerce is to publish lists of possible foreign buyers of American-made goods. The International Institute of Agriculture with headquarters at Rome likewise serves a useful purpose by collecting and disseminating information upon current supplies and needs for agricultural products. All such agencies, through publicity, enable business men to form more rational judgments and thus to compete more intelligently. The result is a reduction of business risks.

The possibility of fraud or bad faith is, likewise, a risk that always exists to a greater or less degree in transactions of purchase and sale. To the buyer, there is the possibility of misrepresentation by the seller of the quality or quantity of the goods involved or the failure of the seller to deliver the goods as agreed in an advance contract. To the seller, there is always the possibility of unwarranted cancellation of orders or failure to make payments as agreed. Risks of this class, like the others mentioned, are primarily individual risks, that is, the consequences must be borne primarily by individual traders. But the public also has an interest in the honest and fair conduct of business, for business will be carried on more freely and thus competition, with its resulting benefits to the community at large, will be more active when business men can proceed with confidence. Mutual confidence among traders is truly the basis of all business, and especially of such complex relations as characterize modern business. It is, therefore, one of the primary functions of government to prevent fraud and secure the observance of contracts.

Another risk, somewhat similar in its effects to the one just mentioned, is the possibility of business failure.

These forms of risk, all or most of which inhere in nearly all forms of trading, bear more heavily upon foreign trade than upon our domestic trade. Means of communication between many parts of the world market are less effective and more costly; and, therefore, less accurate information is available to traders. This is true both of general information on economic conditions and also of more specific information concerning the demand and supply of particular goods in the world markets.

The longer time required for transportation of goods, likewise, enhances risk, especially the risk of price change. As our commercial system is organized, most foreign buyers are themselves traders who expect to resell at a profit. Obviously the chance of an adverse price movement between purchase and sale varies directly with the time elapsing. This time element as a source of uncertainty is much more marked in trade with some countries than with others, for not only does the ocean transportation consume time, but often the end of the ocean voyage is only the begining of a long and tedious overland haul. The fact that risks arising out of this burdensome transportation are usually shifted by the seller to the importer by the terms of the sales contract and often shifted by the importer to some other buyer, does not alter the fact that the risk does exist, that the bearer of the risk must ordinarily be rewarded, and that this reward must finally affect the margin existing between the price paid by the final consumer and the price received by the producer. That is, it makes the conduct of international trade more costly than that of domestic trade.

The differences in language make it more difficult to bring about an exact meeting of the minds of the buyer and seller. Different standards of conduct and commercial practice likewise cause difficulty. Different legal systems and the limitations often placed upon the rights of foreigners in the courts as well as the greater expense of legal proceedings in courts of distant foreign countries, often make it impracticable to obtain legal redress for

losses suffered. In a word, then, the risks of foreign trade, though similar in kind to those of domestic trade, differ materially in degree. This is one of the handicaps which deters business men from extending their sales activities to foreign lands.

The Minimizing of Risks

We have noted two kinds of risk in trade—risk of physical damage or destruction of goods and risks arising from business relations. We have now to note the remedial measures for lightening this risk burden.

They are of two major types: (1) eliminating, minimizing or reducing the losses themselves and (2) shifting risks. There are at least three ways of shifting risks: (a) simply passing the whole risk to another person, *e. g.*, another trader for a reward in the form of a fee or of an adjustment of the price of the goods being sold, (b) diffusing the risk among a great many risk bearers, thus reducing the uncertainty. This is the principle of insurance; (c) neutralizing risks—making one risk offset another in such a way that a loss from an unforeseen occurrence will be balanced by a gain incident to the same occurrence. This is the principle of hedging. These remedied measures will be discussed in the order mentioned.

The only complete remedy is the eliminating of the losses themselves. As long as losses occur they act as a drag upon that free interchange of goods which is essential to the most effective international division of labor. Efforts to reduce the chance of loss are especially effective when directed toward the risks of physical damage to the goods. Much has already been done to this end. The displacing of sailing vessels by steam vessels has done much to reduce the chance of loss of the cargo from storms. The reduction in risk on this account is indicated by the difference in insurance rates on goods shipped in the two types of vessels. The establishment of load lines for vessels by the governments of the commercial countries and the inspection of vessels by government agencies and by associations allied with insurers conduces to higher standards of safety at sea. Inadequate port

facilities or utter absence of such facilities, as at some of the west coast cities of South America, is another source of danger in transportation which is being gradually improved with the growth of commerce. The charting of dangerous channels, the general use of wireless communication, the setting of higher standards of qualification for masters and crews—all these, and many other technical refinements, are reducing the risk of actual loss of the ship and cargo.

Minimizing the risk of price change is a more difficult problem. It can only be approached by an indirect route. Anything that can be done to give a sound basis for prognostication is a step in the right direction. Much has already been done with some staple products, *e. g.*, wheat, cotton, wool, and sugar. With these products the bargaining on the organized exchanges gives a reasonably accurate index of the tendencies of supply and demand and the international news service disseminates this information quickly. Necessarily, such progress must be slow in those manufactured specialties which are coming to play such a large part in our foreign trade.

Risks of bad faith, sharp practices, and insolvency of foreign buyers are being met by more intimate acquaintance of traders with the business men and commercial practices of foreign markets. The work of associations such as the American Manufacturers Association and associations of credit men, whereby information concerning credit risks and the general reputation of foreign business firms is freely exchanged, is designed to reduce this risk. Credit men, who in almost every organization are now charged with this duty, are in a position to form a reasonably sound opinion of the financial standing and the reputation for fair dealing of foreign firms. By making the approval of the credit man a necessary prerequisite to the opening of an account these risks are reduced very materially.

The danger of becoming involved in burdensome legal controversies in foreign countries is enchanced by the ignorance of traders of one country with the laws of other countries and with the interpretation of those laws in the foreign courts. Two lines

of improvement in this respect appear to be feasible. First, there is the possibility of standardization of business law. There are marked limitations upon this in the fact that the very basis of the legal systems of countries differ. Generally the legal systems of the English-speaking countries bear a more or less close relation to one another through their origin in the English common law. The laws of the Latin countries, on the other hand, differ materially from those of the former group. As far, however, as the enactments of legislatures are concerned, there is some tendency to take into account the prevailing practice in the leading commercial countries. This is often encouraged by the desire of the economically backward countries for trade and for loans of capital from the commercial countries. A second remedy offered for this difficulty is the establishment of commercial courts in some countries for facilitating the settlement of disputes of a purely business nature. In these courts much of the involved legal proceedings is eliminated and cases are decided by arbitrators versed in the commonly accepted usages of the particular trade.[1]

The Shifting of Risks to Traders

Failing, however, in the elimination of such losses—and complete elimination, of course, is inconceivable—much may be accomplished by shifting risks. A risk is shifted when the burden of the possibility of loss is passed by one individual or group of individuals to another individual or group. A reward is sometimes, though as we shall see, not always, paid by the former to the latter for the assumption of this burden. This reward may be in the form of a definite fee or charge, as when an insurance company assumes the risk burden, or it may be in the form of a lower price which the seller accepts for his goods when he is relieved of risk than when he bears it. They both amount to a payment or reward for bearing the risk burden.

The incidence of the burden may be arranged between the

[1] The United States Chamber of Commerce and the International Chamber of Commerce, with which it is affiliated, are encouraging the establishment of boards of arbitration for the settlement of business disputes both in domestic and foreign trade.

buyer and seller by the terms of sale. The seller may assume all risks of transportation and fluctuating freight rates by a quotation of price with terms "F. O. B. destination." Under such terms the seller is required to deliver the goods in satisfactory condition at the buyer's place of business. He, in turn, will usually pass part of the risk to the transportation company and part to the insurers, but he is finally responsible to the buyer. "F. O. B. export point" is similar to the preceding term except that the seller's risk ends and the buyer's begins when the goods are safely on board the vessel at the port of shipment. "F. A. S." (free along side) limits the buyer's risk to placing the goods on the wharf ready for loading. The distinction between "F. A. S." and "F. O. B. export point" is important when loading facilities are inadequate. "F. O. B. factory" places the risks of transportation entirely upon the buyer from the moment the goods are loaded upon the cars at the seller's place of business. The "C. I. F." quotation indicates that the price quoted covers cost of the goods, insurance, and freight, *i. e.*, the ordinary expense of getting goods to the buyer. It does not mean that the risk rests upon the seller. Any loss not covered by customary insurance falls upon the buyer. The "F. O. B. destination" and "C. I. F." quotation are sometimes confused. In the former case the risks rest in the first instance upon the seller, who ordinarily protects himself, in part at least, by insurance; in the latter the risk is upon the buyer and the seller merely agrees to pay for the insurance for the buyer's benefit.

In most outright sales in foreign trade the buyer assumes the risk of price change in the time intervening between his purchase and his sale. Sometimes, however, goods are shipped on consignment, under which arrangement the consignee acts merely as an agent, sometimes with liberty to return the goods if they are not salable or to sell at the best price obtainable. Goods made to order upon the basis of samples or specifications are usually sold at a predetermined price, and here the risk of changes in cost of manufacture rests upon the seller. The manufacturer may protect himself by advance contracts for supplies and the supply

houses in turn may be protected by similar contracts. It is apparent, however, that not all the preliminary stages of manufacture can await orders and, therefore, that an indefinite pushing back of the risk by this contracting process is impossible.

The manufacturer and the foreign buyer may both shift risks to certain middlemen of foreign trade. Thus if a manufacturer sells his goods for the foreign market to an over-seas merchant he receives payment in this country for goods delivered in this country. An export commission house similarly accepts delivery of goods in this country and assumes all risks of dealing with the foreign importer. These are all cases of shifting of risk. Whatever device may be used, prices ordinarily adjust themselves so that the persons who bear this burden will be rewarded. The manufacturer selling goods abroad must decide, considering his resources and the nature of his business, whether it is wise for him to bear the risk and get the higher price or to shift the risk to another and content himself with the lower price.

The Shifting of Risks by Insurance

Risk arising from the possibility of physical damage or loss of goods is commonly shifted by insurance. Because the greatest risks of this kind in foreign trade arise from the dangers of ocean transportation we are principally concerned with marine insurance.

A word, however, should be said concerning the principle of insurance in general, for all forms of insurance are fundamentally similar. Risk does not attach itself to all losses but only to those losses which are fortuitous. The primary characteristic of risk is uncertainty. But the uncertainty of losses of this kind becomes less as the number of risks becomes greater. Whether disaster will overcome a ship on a specific voyage is a matter of pure speculation. If, however, we consider a hundred vessels of varying types and sailing on different voyages we can be practically sure that not all of them will meet with disaster. Now if all these vessels were owned by one corporation it is apparent that the risk burden would be proportionately less than if the one hun-

dred vessels were individually owned. Further, the profits of those vessels which completed their voyages safely would offset the losses incurred on account of vessels which met misfortune. This lessened uncertainty can be brought about without actual common ownership of the vessels. The owners may proceed as though for this particular purpose they did own the vessels jointly. They may agree in advance that the losses which fall upon some shall be borne by all through assessment upon all the owners. This is literally done in some types of insurance. If, however, a long history of losses is available, they will show for the entire group a certain degree of regularity and, therefore, the rate which each owner will be called upon to pay can be fixed in advance and losses paid out of these previously collected "premiums." That is, the shipowner "buys" insurance without any regard for the policy followed by other owners. This, however, should not obscure the fact, which is at the basis of the whole system, that it is the existence and combination of a large number of independent risks that makes it possible for the insurer to grant individual protection and, further, that the losses are paid in the long run from the premiums contributed by the individual owners. Therefore, insurance, of whatever form, is essentially mutual; since the premiums are fairly regular and uniform they come to constitute a regular item in the cost of doing business, and, therefore, in the long run are passed to the shippers of goods as part of the freight rate and by them they are presumably passed on to the consumer in the price of the goods transported. The principle of insurance, therefore, substitutes relatively small but certain costs for large uncertain losses and thereby makes it possible to incorporate these costs in an orderly way into the total cost of producing and distributing goods.

The term "marine" insurance covers both the insurance taken by the shipowner for protection against loss or damage to the vessel and insurance arranged by the owner or purchaser of goods to indemnify him against loss or damage to the cargo. There are certain differences between hull insurance and cargo

insurance, and in practice they are usually represented by separate contracts or policies.

Hull insurance is practically universal. The owner of a vessel has an immense burden of risk in the many possibilities of damage to, or total loss of, his vessel. This will be seen if we compare the steamship business with railroads. A railroad company has its capital invested in permanent right of way, which is not subject to great and unexpected damage, and in locomotives, cars, and buildings, which are distributed over a very wide area. Therefore, no single catastrophe is likely to affect more than a small part of a company's property. The company is almost certain in the course of a year to suffer losses, but these will be a series of relatively small losses, and the total losses in any considerable period can be predicted with a reasonable degree of accuracy. Funds can, therefore, he held in readiness to offset such losses, or they can be deducted from earnings as an expense of operation. The principle of self-insurance is applicable to the railroad company's risks. The capital of a shipping company, on the other hand, is concentrated in a few units, any one of them subject at all times to total loss. This is a very grave possibility to even the largest of the modern companies, and, when we remember that most of the world's shipping is owned by enterprisers possessing only two or three vessels, it appears that, if it were not possible to obtain protection against these great risks, few capitalists would be willing to invest their capital in the industry. Insurance of vessels is thus seen to be essential and in fact it was one of the earliest forms of insurance to develop.

While the shipowner, therefore, insures the vessel, the owner of the goods shipped insures them. The reasons for cargo insurance by the shipper are to be found in the very limited liability assumed by the ocean carrier. Whereas a railroad assumes almost complete responsibility for the delivery in good condition of the goods intrusted to it, the ocean carrier is absolved from this burden by the terms of the bill of lading and by law. These limitations were described in Chapter XII.

The risks of ocean transportation differ somewhat from those of land transportation. They may be classed as, first, risk of total loss of goods or of the ship or both, as the case may be, second, risk of partial loss or damage, and third, risks of general average assessment. The risk of total loss arises from the possibility of sinking, fire, or capture. There is also a constructive total loss whenever the goods or the ship are so badly damaged that they may be properly abandoned. Partial loss or damage may arise from a number of causes, among which may be mentioned fire, contact with sea water, pilferage, and breakage.

General Average

The risk of general average assessment calls for explanation. The owner of a vessel and the several owners of the cargo are on every voyage engaged in a common adventure. Many perils threaten all of them alike. Now if a storm arises which endangers the ship and cargo as a whole, as well as the lives of those aboard the vessel, it may become necessary to lighten the vessel by throwing overboard a part of the cargo or by cutting away a part of the ship's rigging or otherwise sacrificing a part of the property involved in the enterprise. It obviously would be unjust to place this loss solely upon the shoulders of the unfortunate individual whose goods were sacrificed in order that the remainder of the property might be preserved. Rather it appears that the loss should be borne by all the members of the enterprise in proportion to the amount of property which each has at stake. The justice of this common-sense view is recognized in the principle of general average.[1] The principle is that any loss or expense brought about voluntarily by the master of the vessel for the purpose of protecting, and which actually does protect, the interests of all parties involved in the enterprise from some fortuitous and unforeseen danger, shall be borne by all parties proportionately to the equity of each in the enterprise, *i. e.*,

[1] The almost universal justification of the principle is suggested by its antiquity. It is found in the Rhodian Laws of the third century B. C. and is thought by some to have been a well established principle, even before that time. It is found in the Roman Civil Law and in the laws of the seafaring countries of the Middle Ages.

in proportion to the value of the property or rights which each party has at stake. Freight payments due to the carrier on the goods being transported is recognized as part of the carrier's equity in the enterprise. It should be especially noted that the principle of general average exists quite independently of insurance against it. The principle arose long before the development of marine insurance. The possibility of assessment upon one's property under the principle of general average should be viewed as one of the risks of ocean transportation comparable to loss by fire.

Certain conditions must be fulfilled in order that a loss may be distributed under the principle of general average. First, the sacrifice or expense must be voluntarily made. If the ship or part of the cargo is accidentally injured, say by fire or the force of a storm, losses so suffered would not be distributed under the principle of general average. Such events, however, may lead to sacrifices for the general good, and these voluntary sacrifices would be subject to general average distribution. For example, if a ship should accidentally run aground, the damages resulting to the vessel would rest only upon its owners. But, being stranded, the whole enterprise—ship and cargo—is subjected to peril. In floating the vessel in an effort to avoid this common peril its mechanism is voluntarily subjected to unusual strain. Damage caused in this manner may be recompensed by general average assessment. It is evident that a question of great nicety is raised, as to how much of the damage was caused by the stranding itself, and is, therefore, to be borne by the shipowner, and how much of it resulted from the voluntary act of attempting to float the vessel, and is, therefore, to be distributed. Second, the sacrifice must be designed to protect the interests of the enterprise as a whole, and it must be in some degree successful. If, because of, or in spite of, a sacrifice designed to protect the common interest, the whole is lost, the losses must be borne individually. Third, the event which leads to the expense or sacrifice must be fortuitous. A vessel in distress, as a result of exceptional storms, seeks a port of refuge.

Pilots must be paid, and part of the cargo must be unloaded to reduce the draft of the vessel. These expenses are subject to the principle of general average. Expenses of the same sort at the port of destination are, of course, to be borne by the carrier, for they were to have been anticipated in the normal course of the voyage.

The loss or expense is prorated according to the equity of each party to the enterprise. A simple example may make this clear. A vessel valued at $100,000 carries a cargo which is valued at $80,000. The ownership of the cargo is distributed among four shippers as follows: A's goods, $10,000; B's goods, $20,000; C's goods, $20,000; D's goods, $30,000. Freight to be paid upon completion of the voyage amounts to $20,000. In the course of the voyage it becomes necessary, on account of unusual storms, to lighten the vessel. B's cargo is, therefore, thrown overboard. This is judged to be a reasonable expedient and to have contributed to the common safety. The expense of $20,000 is, therefore, distributed. The various equities, the proportion which each bears to the whole, and the assessment of each is set forth below.

	Equities	Per Cent of Total	Assessment
Ship	$100,000	50	$10,000
A's cargo	10,000	5	1,000
B's cargo	20,000	10	2,000
C's cargo	20,000	10	2,000
D's cargo	30,000	15	3,000
Freight	20,000	10	2,000
Value of total enterprise	$200,000	100	$20,000

In practice, the problem of adjustment is not often as simple as this. In a modern freight carrier, loaded with general cargo, there may be a hundred or more lots of cargo. The damage is likely to fall immediately upon several, or possibly all, interests. There is often a difficult problem in separating the part of the loss subject to general average from that which is not. The values which shall be assigned to the several interests is another

vexing question. Ordinarily, the values taken are those obtaining at the port of destination for the ship and goods in the condition in which they are found at the time of arrival. The appraisal of a ship in a damaged condition and in a foreign port is an extremely difficult matter. All these questions are decided and a complete adjustment made by professional general average adjusters, according to the laws of the country in which the adjustment is made, unless some other rules prevail by virtue of a provision of the bill of lading. It is now customary to specify in the bill of lading, that general average is to be adjusted according to the York-Antwerp Rules of 1890. These rules were laid down by international agreement in an attempt to standardize practice.

The risk of assessment of this kind rests upon shipowner and shippers in the first instance, but it is practically always shifted to insurers by the marine insurance policy. The principle was established long before even the most primitive forms of insurance were known. It is questionable if the principle would have become established at all, if there had been at the time a system of insurance, for it is clear that insurance could be so arranged as to assume all the risks of this class directly. The carrier could insure against the risk of losses judged to be necessary for the common safety, as well as against purely fortuitous damages. The cost of insurance, as a whole, would be no higher than at present; for even under the present system losses as a whole are borne by the insurers as a group. The principle of diffusion of risk could as well be carried out by direct insurance as by this indirect process.

An abandoning of this principle might actually reduce the risk burden, because now there is added to the actual loss which has been suffered the uncertainty of how that loss is to be distributed and also the expense and delays incident to the adjustment itself. In ancient commerce the risks, giving rise to general average, were comparatively few, and the distribution of losses was a simple task. The Rhodian Law refers particularly to jettison—casting of goods overboard to lighten the ship. But to-

day, although the principle has remained essentially unchanged, its application has become increasingly complicated. The adjustment of a general average loss sometimes requires years of time and involves the employment of experts during all this period. The adjustment plans submitted to underwriters and shippers sometimes fill two or three bulky volumes.[1]

In opposition to this view it is urged that the knowledge that any losses will be distributed over the whole enterprise, including the ship, effectively deters shipmasters from too hastily deciding to sacrifice part of their cargo. This argument would be much more effective in the absence of present insurance methods. But when the burden of possible assessments is to be borne by the insurers for a premium previously fixed upon, it appears that this wholesome influence is nullified.

Briefly then, the view expressed above is that the principle of general average arose under very primitive conditions, and that it was, under those conditions, an eminently practical method of dealing with a serious problem. It provided for a simple diffusion of risks among the members of a common adventure. But the growth of marine insurance to the point of its present universal use has brought about a much more effective diffusion of risks, not among the parties to the enterprise but among the various insurers. The necessity for the former plan has thus disappeared, and its operation merely entails a great amount of costly and possibly useless labor.

Other Risks Assumed by Insurers

Partial losses arising from purely fortuitous causes are also designated as average—particular average, to distinguish them from the general average losses just discussed. Some writers question the propriety of the use of the term average in this connection.[2] However, it is now commonly understood to

[1] On adjustment of general average, *cf.* Winter, W. D., *Marine Insurance*, Chapter 18.

[2] For example, Stevens, *On Average*, pp. 1–3 holds that the term average implies general contribution. Concerning "general average" and "particular average" he says: "The first is the only one properly entitled to the appellation. The second is made use of by foreign writers, merely in opposition to the first, or as a means of showing that the damage incurred

mean loss, damage, or expense, short of total loss of the thing insured. Thus general average is a loss damage or expense which must be shared generally by all parties to an enterprise. Particular average is a loss less than total which must be borne by the particular party upon whom it directly falls. Total loss, unless it falls under general average, is also, of course, borne individually. It is, however, not included under the lead of particular average, but is considered as a third class of risk.

These particular average losses may arise from many causes, not all of which are covered by the ordinary insurance policy. The insurance contract states them as follows: "Touching the adventures and perils which the said (insurer) is contented to bear, and takes upon itself in this voyage, they are of the seas, men-of-war, fires, enemies, pirates, rovers, thieves, jettisons, letters of mart and countermart, reprisals, takings at sea, arrests, restraints and detainments of all kings, princes, or people, of what nation, condition or quality soever, barratry of the master and mariners, and all other perils, losses and misfortunes that have or shall come to the hurt, detriment or damage of the said goods and merchandises, or any part thereof."

This statement, however, must be viewed in the light of the long line of judicial interpretations, which have materially restricted the liability of the insurers. In the first place, the term "perils of the sea" is distinguished from "perils on the sea." The former are covered, the latter only when specifically mentioned. Damage from storm is a danger *of* the sea; damage from fire is a peril *on* the sea and is covered only by virtue of its specific mention. The clause referring to all other perils would seem to cover every loss of whatever kind, but in fact the courts have construed this to mean "other perils of like nature." Perils which cannot be classed as fortuitous are not included. Thus some articles by their very nature or due to inadequate packing

is a particular loss, and is not, therefore, a subject for general contribution, *i. e.*, it is no average at all."

The etymology of the word is obscure. Some students trace it through the French "*avarie*" thus emphasizing the idea of damage; others find a connection with the Teutonic "*halverage*" and allied words thus suggesting partnership. Both ideas are involved in the present usage.

are almost certain to depreciate, and a vessel suffers constant depreciation from the ordinary wear and tear of service. These are not covered.

There are two clauses or memoranda ordinarily attached to the policy which further limit its scope. First, certain articles, particularly liable to breakage or to deterioration, are warranted free of average unless general. That is, these articles are insured against total loss or assessment on a general average loss but not against partial loss of a fortuitous nature. In the list of such products is included grain of all kinds and all other articles that are perishable in their own nature. Another list of articles are free from particular average under 20 per cent, another under 10 per cent, and another group under 7 per cent. Second, the liability of the insurers is limited to peace conditions by a clause which warrants the insurers to be free from loss from operations incident to war. This contradicts and supersedes the references to men-of-war and similar agencies in the general statement of liability. When war is declared this nullifying clause may be stricken out in consideration of a special premium or the war risk may be assumed by a different insurer. Likewise, the exceptions made against perishable products may be waived by a special policy for which a higher premium may be paid. It is common practice, however, to warrant the insurer free from particular average under some specified proportion.[1] The likelihood of some minor damage is so great, and the need for adjustment so frequent, that the insurance premium for total protection would be practically prohibitive.

Types of Insurers

The insurers may be either individuals or corporations. The former are much the older and even to-day they are very important. We have referred in a previous chapter to Lloyd's Coffee

[1] Such an arrangement is indicated by the term "F. P. A. five per cent" (free of particular average under five per cent). The term "F. P. A." when not so qualified refers to insurance against total loss and general average but not against particular average. "F. A. A." (free of all average) limits insurance to the risk of total loss. These terms are commonly employed by the buyer when giving directions to the exporter for insurance to be taken out by the latter for the account of, and at the expense of, the former.

House in London in which shipowners and shippers were wont to meet and transact business. Persons who were willing to assume risks on vessels and cargoes also congregated there. From this humble beginning arose the association of Lloyds, which was finally incorporated in 1871. The fact that Lloyds is a corporation, with agents in all ports of the world should not obscure the fact that the members of the organization assume risks as individuals, not as a group. The functions of the corporation are essentially those performed by Lloyd as proprietor of the coffee house. They are, first, to provide a meeting place for insurers and representatives of shippers and shipowners; second, to lay down and enforce rules of admission and conduct of members and otherwise to protect the mutual interests of underwriters; third, to gather, compile, and diffuse information concerning shipping.[1]

The procedure in procuring insurance at Lloyds will perhaps make clear the nature of the organization. A broker, desiring insurance for his principals, prepares a statement of the risk together with the proposed premium. He then takes this "slip" to the several underwriters individually. The underwriter, if he desires to accept part of the risk, indicates the amount, often a very small part of the total desired, and signs his name opposite it. An important feature of the system is that he may also sign for amounts specified by him for other parties who are not active members of the exchange. These "names," as the persons so represented are called, must, however, be approved by the corporation and must have deposited with the corporation a sum of money which is, partially at least, a guarantee for the faithful observance of contracts made by their agents, the active underwriters. This "slip" signed by several underwriters of Lloyds for the total amount desired, forms the basis for the policy, which is likewise a contract with insurers individually. In case of loss the insurers' liability is unlimited. In case of total loss the process of collection is simple; in case of partial loss the adjustment is made by professional average adjusters. It may seem, at first

[1] The last-named function is performed by a nominally independent organization, which, however, is so closely allied to the other that the two can be treated together.

thought, that this would be a very awkward system; because the insured must collect relatively small sums from a great many insurers, every one of whom has the right to oppose payment by legal processes. In fact, however, this is overcome by the common practice of the members of Lloyds following the lead of certain prominent underwriters. It has been called a "bellwether" system both in respect to issuing insurance and paying benefits. In getting insurance in the first instance, if the broker can get a leading underwriter to head his list at a certain rate, the others accept that rate and follow the lead. Likewise in making payments, if one of these prominent underwriters is satisfied with the justice of a claim and pays it, the others follow. If, on the other hand, there is some question of the legality of the claim, a suit may be brought against only one of the underwriters. The decision in that case is accepted by all.[1] It thus comes about in practice that a merchant has usually no more difficulty in collection on a Lloyds policy than on a policy issued by a single insurance company.

By the system described the risk is diffused between several insurers. A large risk such as, for example, that of the ill-fated Titanic will have a great many insurers. The tendency is for insurers to take relatively large amounts on single ventures, if they be considered comparatively safe, and smaller amounts on the notoriously dangerous lines of business. The risks are well distributed according to the desires of the insurers. In the group of underwriters will be found some who are very conservative and others who are inclined to speculate. Each can select the type of business he wishes. Still others desire a well-balanced business with some speculative ventures yielding large profits and other more conservative ventures to give stability. These also can be satisfied. As a result of this varied demand, almost anything can be insured at Lloyds, for someone is always to be found willing to assume the risk, or at least a small part of it, if the premium be large enough. From the point of view of the

[1] *Cf.* Testimony of Wm. H. McGee in *Hearings on Marine Insurance* before the House of Representatives Committee on the Merchant Marine and Fisheries, 66th Congress, 1st session (1919), p. 114.

insurer his risks are distributed by the fact that he has insurance on many ventures of different kinds and in different parts of the world.

Insurance was long conducted solely by this method, but now the insurance companies are coming to play an important part. These companies often combine marine insurance with fire, and other forms of property insurance. The insurance company has larger resources than individual insurers. It can thus assume larger risks. One insurer may issue a policy for the total amount of insurance desired on a single transaction. It may in turn reinsure with other companies or with the individual insurers of Lloyds, but this does not affect the relation of the original insurer to the insured. Although the companies do assume some large risks, reinsuring them if necessary, it seems that they are best adapted to insuring cargoes or parts of cargoes, while insurance on the ships is likely to go to Lloyds. Cargo insurance is often taken for the single voyage, while hull insurance, which is naturally in larger lots, often for a whole fleet of vessels, is arranged by the year. Less detail is thus involved in hull insurance, and also a very small difference in rates plays a more important part. It has thus come about that there is a more highly competitive and more truly international market for hulls than for cargoes.

A disadvantage of company insurance, from the point of view of the insured, is that the liability of the individual stockholders is limited to the amount of capital contributed by each. This weakness, however, in practice is largely offset by the fact that the resources of the company are easily ascertainable, and that their affairs are subject to government inspection. Generally, the companies try to confine themselves to the more conservative ventures, while the more speculative ones are insured at Lloyds. Again, the cost of administration is higher for the companies, because they must maintain large accounting and actuarial departments. In addition to these two types there are also some mutual organizations for marine insurance.

Having noted these various methods it is well to reiterate that

they are all, in a fundamental sense, similar. Whether the business be carried on by individuals, corporations, or mutual associations, it must depend upon payments made by all the insured to reimburse those of the insured upon whom the losses fall. Losses are not ordinarily paid from contributed capital, but the capital resources are merely in the nature of a safety fund to provide for abnormal losses.

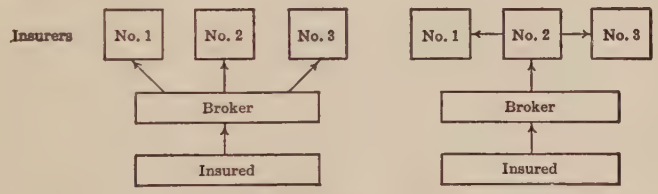
It is futile to ask which of the various agencies for insuring against risks is the most important. They are all parts of a great system which as a whole assumes the risks as a whole. The great number of insurers—individual, corporate, and mutual—large and small, domestic and foreign, enable risks, no matter how large, to be distributed in such a way as to make it possible for the system as a whole to withstand the shock of even the largest individual losses.

Marine insurance is more often arranged through brokers than with the insurers directly. Unlike the practice with other forms of insurance the insurers rarely have agents representing them as solicitors. The broker, who takes their place, represents the insured, but he occupies an anomalous position, in that his fees are paid by the insurers. He assumes the task of placing the whole amount of insurance for the shipper or shipowner, and then purchases it from those insurers who offer the lowest rates consistent with safety. If the insurance needed is large, he commonly distributes it between several insurers, thus getting a higher degree of safety for both the insured and the insurers, and as a result he gets lower rates. The broker's position in marine insurance is explained by the fact that the risks are often very large in proportion to the resources of the insurer and that they are concentrated. Let us say we wish to insure a cargo of coffee from Brazil to Baltimore. Certain insurers have previously assumed risks up to their capacity. Others have so much insurance placed on that commodity or on cargoes in that region that they feel it is not wise to further concentrate their risks.[1] This necessitates find-

[1] Individual risks assumed by even the largest companies are relatively small. Of 80 American insurance companies reporting for 1918 to the Committee on Merchant Marine and Fisheries, only one showed as much as $500,000 on a single hazard, only 9 exceeded

ing others to whom such a risk will appeal. Finally, some insurers may be found who are willing to give insurance in that trade but are not willing to assume so great a risk on a single venture. This situation is met by splitting the risk into several parts, each insurer taking one part. All this is the function of the broker. He facilitates the diffusion of risk and thus assists in the performance of the most essential part of the insurance task.

Almost the same result may be brought about by the practice of reinsurance. That is, although one insurer accepts the entire liability to the shipper he passes part of the risk to other insurers.[1] This shifting of the risk by the original insurer may take place even after news arrives that the property insured is in peril or has been damaged. Of course, the rates under such circumstances are very high. The relations between the parties involved in these two methods of distributing risks are illustrated in the following diagram in which the passing of the risks is indicated by the direction of the arrows and the insurers are distinguished by numbers:



The process of obtaining insurance may be simplified, in the case of a shipper having a large and continuous business, by use of an open policy. This type of policy grants insurance on a considerable amount of cargo. As individual shipments are made they are declared to the insurers who issue certificates against the specific shipments. The certificates are used for financing purposes. They indicate that insurance has been arranged, but they themselves do not constitute the real insurance contract.

$100,000 on single hazards; and the great majority of them confined their business to individual hazards of less than $100,000. S. S. Huebner, Report on the Status of Marine Insurance in the United States. Approved by House of Representatives Committee on Merchant Marine and Fisheries, February 26, 1920, p. 94.

[1] Recent investigation shows that of the marine insurance written by companies operating in the United States about 41 per cent was passed on to others by reinsurance. *Ibid.* p. 19.

As mentioned in the discussion of financing foreign trade the insurance certificate is, next to the bill of lading, the most important document attached to a documentary draft. The certificate in this case is, of course, indorsed in such manner as to make the insurance payable to the bank which has advanced funds on the security of the goods.

The Position of London in Marine Insurance

Great Britain is, and has been, the home of marine insurance in modern times. Germany, France, and the United States have engaged in the business to a less extent, but it still remains true that London is the center of the world market for marine insurance. Of the total insurance originating in the United States it is estimated that 20 per cent is placed abroad directly and of the remainder, which is placed in the United States, about 58 per cent goes to branch offices of foreign companies, principally British, 5 per cent to American companies said to be controlled by foreign ownership of their capital stock, and only 36 per cent to *bona fide* American companies.[1]

Various explanations are given for this. Some hold that it is due to certain legislative obstacles to the development of the business in this country. Chief among these obstacles are said to be the taxes levied upon the marine insurance companies by the several states. There has been little uniformity of taxation and the rates appear to be very high. The rates are said to be much higher than the corresponding tax rates in England. There are legal obstacles here in the anti-trust laws and in special laws referring to insurance companies, which discourage or prohibit such intercorporate relations between insurance companies as are common abroad, and there are also legislative prohibitions in many states preventing companies from engaging in several lines of insurance. While most of the obstacles to the successful development of marine insurance in the United States also apply to other lines of insurance, they are more serious in this case because of the greater international competition for marine insur-

[1] S. S. Huebner. *op. cit.*

ance. This international competition is especially pronounced in hull insurance, of which American companies handle only a small fraction of the total business originating here.

All these facts are pertinent, but there are more fundamental difficulties which do not originate in arbitrary regulations. One of these is the long and slow development of marine insurance in England. In a business of this kind large capital and surplus resulting from years of accumulation and conservative management are especially important. Likewise, an intimate knowledge of the business, not only on the part of the managers and employees, but also on the part of the investors of capital, gives an advantage to the older commercial country. One of the products of this long development is the institution of Lloyds—an institution which is typically English, in that it is the product of no single stroke of genius, but like the English constitution and the Common Law, has grown gradually by constantly adjusting itself to new needs as they arose. It is very doubtful if such an institution could be successfully established by any other means.[1]

Another reason for England's leadership in this field is to be found in the plentiful supply of capital and the relatively lower rate of return upon it in that country than in our own. Insurance is, like banking, primarily a capitalistic business. Since the rate of return upon capital is normally lower than it is here, investors in the insurance field are content with a lower rate of return than would be attractive to capitalists in this country. Under such circumstances, the English are enabled to grant slightly lower rates, and, in such a highly competitive industry, a very small difference in rates is very significant.[2] It will be recalled that this same factor, the lower marginal return upon capital, was cited as having a similar influence upon ocean shipping and investments. Generally speaking, old industrial countries having fewer opportunities for the profitable investment of capital will, as a result of that fact, have an advantage over the

[1] On the possibility of the establishing of a similar organization in this country, see the testimony of Mr. W. H. McGee, *Hearings* p. 116.

[2] It is also asserted by some that English cost of operation is somewhat lower than our own. This also makes possible lower premium rates.

newer countries in those enterprises which are principally, or wholly, capitalistic in nature, and in which international competition is active.

But aside from the advantages of this or that country it seems clear that an international market in marine insurance is fundamentally better than a national market. It facilitates a more complete spreading of risks, and that is the very essence of insurance. It, furthermore, insures the lowest possible rates. Americans may wish that this international market had its center in New York, rather than in London, but, as to the relative desirability of a national or an international market, there can be little question.

The Shifting of Risks by Hedging

Another principle employed for relieving business men of the risk burden is that of neutralizing or balancing risks. The distinction between this principle and that of simple shifting of risks should be noted. The difference arises out of the fact that some risks involve a chance of loss without any offsetting chance of gain, while in other cases, the possibility of loss is accompanied by an equal possibility of gain. Risks of physical damage or destruction fall in the first group, while the risk of price change is in the second. When an owner of goods ships them overseas he assumes several risks of the kind discussed in connection with marine insurance. It will be clear that two possibilities confront him: (1) The goods may escape injury, in which case there is no loss nor any positive gain, or (2) the goods may be damaged or destroyed, in which case there is a positive loss. On the other hand, there are some risks which are accompanied by a possibility of gain. A merchant buys goods which he will not be able to sell for some time. He is said to assume risk, *i. e.*, the danger of the price declining while he holds possession of them. But there is just as great a possibility that the price will rise, in which case he would gain. There are, in fact, three possibilities: (1) the price may not change at all—result, no loss, no gain, or (2) the price may fall—result, loss to the owner, or (3) the

price may rise—result, gain to the owner. Now leaving aside the operation of those forces which can be foreseen, and, therefore, which cease to give rise to risks at all, it is clear that the chance of gain is as great as the chance of loss. In this class of risks, therefore, any large number of transactions, extended over a considerable period of time, would result in a balancing of losses and gains. In the preceding group, however, a large number of instances are sure to show a net loss. In order to persuade other persons to assume the risks of the first class, traders must pay them a net sum calculated to offset the losses. Or traders may combine their risks, paying a certain present sum to offset the losses which are uncertain for individuals but certain for the group. These devices we have designated as simple shifting and shifting by insurance. But for risks of the second class it is only nesessary for a trader to place himself on both sides of the market, *i. e.*, to assume the position of buyer as well as seller of a commodity. Any price movement will then result in a balancing or neutralizing of gain and loss.

A common application of this principle is in the practice of hedging. Hedging may be defined as the making of a pair of transactions of opposite nature, in which the loss (or profit) on the original transaction is offset by a corresponding profit (or loss) on the hedging transaction. If the original transaction begins with a purchase and ends with a sale, the hedge must begin with a sale and end with a purchase. We may illustrate a hedging transaction as follows: Assume that a grain exporter in Chicago has purchased wheat to be sent to Liverpool, there to be sold by a broker. There is normally a difference in prices between the exporting market and the importing market, the margin by which the latter exceeds the former being sufficient to cover the costs of exporting and importing and a sufficient profit to keep the traders in the business. Let us assume that this difference is normally twenty-five cents on a bushel of wheat. We may further assume that our exporter is satisfied with the trading profit remaining after transportation and other charges have been deducted from this normal "spread," and that he

is not seeking a speculative profit from price change. That is, he is dealing on the margin between prices in different markets at the same time; not on the divergence between prices at different times. He can avoid the consequences of fluctuations in price by hedging. On September 1 he buys wheat in Chicago at $2.00 a bushel and on the same day he sells for delivery in the future some product, the price of which he believes will move with the price of the wheat which he has bought. In practice this would likely be the same product, wheat, for delivery some time in the future, say in the following May. He, therefore, enters into a contract, whereby he agrees to deliver wheat of a specified grade on the Chicago market in the following month of May. For this promise he receives, say, $2.07 a bushel on the wheat involved. Prices then, on the day of purchase, September 1, as follows:

Chicago "spot" price	$2.00
Liverpool "spot" price	2.25
Chicago "May" price	2.07

The contract to deliver wheat in the future has a market value, which will normally rise and fall with the price of actual or "spot" wheat, *i. e.*, wheat deliverable in the present. The Chicago spot price and the Liverpool spot price also have a marked tendency to move together. Now suppose that on October 1 when his wheat arrives in Liverpool the price is only $2.05, a decline of twenty cents. After allowing for transportation costs, commissions, and his normal trading profit, he has lost twenty cents on his exported wheat due to price change. But now we can safely assume that the price of "spot" wheat in Chicago has also declined by twenty cents and, likewise, the price of "May" contracts has declined. He can, therefore, buy back his "future" contract for, say $1.87. It is not necessary that he should repurchase the identical contract which he entered into on September 1. If he buys a "May" contract for the delivery of the same amount of wheat which he is under obligation to deliver in May, it is clear that, for all practical purposes, he is out of that transaction, for his duty to

deliver wheat in May is just offset by his right to receive wheat in May. He received $2.07 for entering into this future contract; he is able to free himself of it for $1.87. He has thus made a profit of twenty cents a bushel. This just offsets the loss from price change on the wheat exported. We may set forth the transactions in this way:

The Exporter	*Buys*		*Sells*	
September 1	Spot wheat in Chicago	$2.00	May wheat	$2.07
October 1	May wheat	$1.87	Spot wheat in Liverpool	$2.05

The results are:

On Exported Wheat		*On "May" Contract*	
Sold at	$2.05	Sold at	$2.07
Bought at	2.00	Bought at	1.87
Gross profit	$ .05	Profit from price change	$ .20
Expense and trading profit	.25		
Loss from price change	$ .20		

The exporter has made his normal trading profit and has not been affected by price changes intervening between the beginning and end of the transaction. In order to gain this security, he has foregone the chance of profit from prices moving in the opposite direction. This will be apparent if the reader will assume that the price situations above were reversed, *i. e.*, that the low price prevailed on September 1 and the higher prices on October 1. Hedging is thus seen to be the opposite of speculation. Further, either the export transaction or the deal in futures, standing by itself, would involve a speculation; when combined they neutralize one another. The success of the above plan depended upon a more or less fixed relation or spread between the price of actual or "spot" wheat and the price of "May" contracts. The price of the original product and of the product employed as a hedge must move together. These conditions are commonly found in those staple products for which there are organized future markets. The various grains and cotton are the best examples, although the hedging principle is employed in many other raw materials and even in the case of some manufactured goods.

The question may arise, why did not the exporter sell the product at a fixed price before the goods were shipped or as soon as the purchase was made? In fact, this would commonly be done, but in this event the risk would have been shifted by one merchant to another, who presumably was no more desirous of speculating than was the exporter. The importer would, therefore, hedge to protect himself against a fall in price from the time he purchased the product until it arrived in his market and was sold.

Now who does bear the risk? Only two groups of persons are in the transaction for any period of time the exporter and the speculator, or speculators who may be considered as a group. The exporter's transactions neutralize each other; the speculators, however, bought "May" wheat at a high price and sold it at a low price. Had prices moved the other way the profit would have gone to them. This is because their transactions stand alone. A speculator deals on one side of the market; he buys and later sells, or sells and later buys. If he does both simultaneously his chance of profit disappears, and there is no justification for his business either from the social point of view or from his individual point of view. Therefore, while hedging is, from the individual merchant's point of view, an elimination or neutralizing of risks, it is, in a broader view, a shifting of risk from merchants to professional speculators. It differs from simple shifting and insurance in that no fee or reward is paid by the one who is relieved of risk to those who assume it. This is possible, because risks of this kind, which are distasteful to conservative traders, are welcomed by speculators.

CHAPTER XVIII

GOVERNMENT INTERFERENCE IN TRADE

So far we have treated the advantages of international commerce and the principles governing the conduct of foreign trade with relatively little attention to the part played by governments in the control and direction of that trade. This procedure we conceive to be proper, because the fundamental principles are, in fact, quite independent of government regulation. The motivating force in international trade is the profit to be gained by individuals participating in that trade, and, inasmuch as the profit is mutual between the traders involved, this trade would continue without any positive government interference. Most theoretical economists would go further and assert that, since the gains accrue to individuals and these individuals are the best judges of their own advantage, and are presumably most actively interested in advancing their own well-being, the sum of the gains will be greatest if individuals are left free to pursue their own self-interest. Even these economists recognize the necessity of governmental activities in maintaining law and order and enforcing contracts—those elementary activities of government upon which all orderly exchange rests. They would, however, deny the importance of any distinctions between domestic and foreign commerce. In other words, their view of world commerce is cosmopolitan: the individual traders and their transactions are placed in the foreground and the significance of national lines across which commerce passes is minimized. The world is viewed as one great trading area, for economic purposes very much a unit.

On the other hand, another group places the emphasis upon national units and by no means disregards the international boundaries across which trade passes. While they admit that the immediate motive for trade is individual profit, they argue that the effects of trade are widespread and are a matter of con-

cern to the whole community. This being the case, they hold that individual gains cannot be made the sole guide to international commerce but that the state should interfere to direct and mold this trade in such a way as to bring about the desired industrial development of the community. This peculiar development of the industry of the country may be desired for the advancement of the political and military power of the nation, quite regardless of the economic interest of the individuals within it. This object seems to have been uppermost in the minds of some German economists and philosophers. On the other hand, this special shaping of the economy of the country may be undertaken for the benefit, either immediate or future, of all or certain classes of the community. This supposed benefit is economic in nature. That is, according to this line of thought individual self-interest is not the best guide to its own fulfillment but, because the welfare of any one economic group within a country is so dependent upon the activities of other groups, it is necessary for a common authority, the state, to direct the activities of traders along those lines which will bring the desired results. This concept of the proper relation of the state to international commerce is commonly found among those Americans, Canadians, Australians, and others who favor state intervention in foreign trade. This intervention in trade takes many forms, but the chief device is that of a protective tariff. We turn our attention, therefore, to the free trade-protectionist controversy.

Free Trade

The argument for free trade is implicit in the theory of international commerce which has been presented in preceding chapters. Trade is seen to be advantageous because it leads to the production of goods and services by those people and in those places where, all things considered, they can be most effectively produced. Exchange of goods leads, therefore, to the largest possible output for the trading world as a whole and to the largest returns to the producers individually. If, now, trade based upon the individual interests of producers and consumers leads to a

utilization of natural resources in such a manner as to yield the largest returns, it would appear that obstacles placed in the way of the working out of these natural forces could only lessen the advantages to be gained. This, in brief, is the free trade argument. Its force will be appreciated if the principles of trade explained in Chapter I are borne in mind.

But while this theoretical justification of free trade receives all but universal indorsement by American and English economists, it is disregarded as a rule of action by most of the commercial countries,—England, in fact, being the one notable exception. Perhaps on no point of economic policy is there such a marked divergence between theory and the policy of governments. The reasons are not difficult to find. Trade implies specialization; it is the means of distributing the products of specialized workers. If workers were not specialized there would be no need for exchange at all for each would produce for himself the goods which he consumed. For a similar reason, there would be no trade between countries if those countries did not specialize and thus have a relative abundance of some things and a relative scarcity of others. National specialization means the building up of those industries in which the nation has a comparative advantage. This fact is always uppermost in the minds of those who are actively engaged in fostering our foreign trade. They visualize the increased markets for our products and the greater demand for labor by the exporting industries. But as there is only a limited amount of labor and other factors of production within a country the growth of the export industries must be largely at the expense of the relatively less effective industries. The export industries, being profitable, can pay, and in the competition for labor, will pay, if necessary, a relatively high wage. When the less effective industries are forced to pay this wage, as they will be in order to get labor, they find that their costs of production rise above those of foreign producers. Foreign products flow in and submerge these domestic industries. This is a necessary phase of the process of specialization. Specialization, in other words, means not only the building up of some

industries but the elimination of others. It is this undoubted fact that foreign trade promoters are prone to push into the background.

The free trader views this result quite stoically, pointing out that it represents a transfer of our energies from less effective to more effective lines. But the capitalist who has a considerable fixed plant devoted to the pursuit of one of these less effective industries and the worker who has a specialized training in one of these industries cannot be expected, considering the limitations of human nature, to view the working of these natural forces in such a complacent manner. Employers are likely to argue that their difficulty lies in the fact that they have to pay higher wages than do foreign enterprisers engaged in the same line of work and that, in order to protect the domestic standard of living from the competition of the pauper labor of foreign countries, they must have relief through government action. Whatever the reasons may be, they argue, it is a condition not a theory which confronts them and they must either have relief or be destroyed. This, in a country having a representative form of government, is a very effective argument. The free trader may reply that in the long run and in its indirect effects upon the whole country the remedy sought will be more costly than the evil avoided, but this argument fails to be effective for political purposes because it is difficult to show the exact nature of the damage done and to indicate the specific parties injured by the protective policy.

People are commonly much more aware of their interests as producers than as consumers. It is possible, therefore, to enlist the support of the shoemaker for a measure designed to exclude foreign competition in shoes, likewise of the miller for a measure restricting competition in his products, and so with the smith and the farmer and all other producers. The objection that each loses more as a consumer of the products of the other producers than he gains as a producer of his own product calls for a much broader appreciation of the economic forces at work than does the opposing argument. In the actual making of

tariffs each group of producers is willing to support the proposals of other groups for the sake of guaranteeing the adoption of the measure in which it is interested. This practice, commonly called "logrolling," is perhaps of as great significance to one who would understand modern tariffs as are the arguments advanced in parliamentary debates. Despite the high-sounding phrases of party platforms the modern tariff act, as actually passed, is a conglomerate of individual measures, each supported by a very active minority whose interests as producers are directly involved. The effect of this method of tariff making is seen in the difficulty which is experienced by the political party committed to free trade or to a "tariff for revenue only" in putting its policy into effect, even when it is in control of the government.

We venture to suggest that the course of modern tariff legislation is more influenced by these considerations than by the scientific arguments put forth in favor of, or opposed to, the protective policy. This conflict is an example of the very important truth that the reasons which control men's actions are often quite different from the reasoning by which they justify them. As a recent writer puts it, there is a distinction between real reasons and good reasons. The implication is not intended that a careful consideration of the economic principles involved in the tariff controversy is not warranted,—quite the contrary.

Protection

Many of the arguments for protection are crudely mercantilistic although there are others which deserve more serious consideration. One of the arguments of the former type advanced in this country in favor of protection relates to the providing of a home market for domestic goods. It is proposed to foster manufacturing in a country which has been predominantly agricultural. It is argued that a considerable manufacturing industry within the country would cause a demand for the products of the farm and that, therefore, the farmers should be willing to submit to a restriction upon the importation of the

manufactured goods which they wish to buy. That is, they should be willing to suffer a loss as consumers for the sake of a greater gain as sellers of their own products. It is, of course, true that an extensive manufacturing industry would create a demand for the farm products but it is not an additional demand. It merely displaces the foreign market. The trade involved is an exchange of agricultural products for manufactured products. If the manufactured goods are purchased at home, rather than abroad, the foodstuffs must likewise be disposed of at home, rather than abroad. The real question is whether the exchange of agricultural products for home manufactures produced under the tariff will yield, for the same amount of the former, a larger or smaller amount of the manufactured goods than would their exchange for foreign goods. Presumably it will yield a smaller amount, for the domestic manufacturers must produce at higher costs and sell at higher prices than the foreigners, otherwise they would not have required a tariff protection to enable them to establish themselves. The fact is apparently disregarded that trade is reciprocal in nature—that we cannot satisfy all our wants at home and still sell our goods abroad.

The argument that the establishment of industries by the tariff creates an increased demand for labor apparently rests upon the same oversight. If we decide to discourage foreign purchases by import duties we thereby limit our foreign sales of other goods. The new industries represent, not an additional demand for labor, but merely a diversion of labor from the old export industries. The real question is whether the productivity of the labor will be greater when employed in the new industries than in the older ones. That is, can we obtain the goods desired with less labor by producing them ourselves or by producing other goods with which we buy the ones desired. The advantages of trade discussed in previous chapters would seem to supply the answer to this question.

These and other arguments in a similar vein have played an important part in the protectionist controversy in this country. They have received far more attention than their scientific merit

justifies. In the infant industry argument, however, the protectionist is on more tenable ground. This argument is particularly applicable to the fostering of manufactures. We have assumed in our previous exposition that producers will promptly turn to those lines in which they have an advantage. But one of the advantages in manufacturing arises from the experience and economies which result from a long established industry. That is, the mere fact that the industry is established and in possession of the field is a strong point in its favor and may be sufficient to prevent the establishment of competing industries under equally favorable or possibly superior conditions in other countries. The advantage of early possession of the field is especially effective with modern industrial methods by which large investments of fixed capital are required for most effective production. Suppose now that certain promoters desire to establish an industry which on *a priori* grounds appears to be well adapted to the resources and industrial genius of the country. They hesitate, however, to invest their capital in this promising but unproved field because of the probable price-cutting tactics that will be adopted by the established foreign industries in an effort to prevent the rise of the new competitor and because of the normal advantage of the established industry, aside from any definite policy of underselling. Under these circumstances a good case can be made for temporary protection of the infant industry. The protectionist who argues in this vein may even admit the principal contention of the free traders that the protective duty is likely to enhance for a time the price of the product in question. In fact, if the duty did not thus enhance the price it would be of no avail; for the home producer can be benefited only if a higher price is insured than that which would be fixed by free competition. But it is contended that this higher price will be only temporary and that the present loss will be more than repaid by the benefits which will flow from the establishment of a truly effective industry. The desirability of such a measure then resolves itself into a question of fact: Is the industry one which will ultimately be able to stand on its

own feet and is protection needed to enable it to attain that mature state?

Sometimes an argument similar to this is applied, not to one industry alone, but to the whole economic system of a country. Frederick List, a German economist, writing in 1841, developed this argument for protection. List placed great emphasis upon the evolution of countries of the temperate zone from one stage of industry to another and particularly upon the transition from the agricultural to the manufacturing stage. He contended that it was the manifest destiny of certain countries (and particularly he had in mind Germany and the United States) to develop manufacturing. But England had such an advantage from its early start in modern industry that it was possible for its manufacturers to nip in the bud any movement in that direction in other lands. List admitted freely that the immediate economic advantage of industrial consumers dictated a purchase of English goods, but he held that the more abiding interest of the country required that consumers forego those immediate advantages in order to foster the development of an industry which would ultimately be able to withstand the competition of England unaided. For bringing about this desired end, he demanded a general protection for German industries. By building up these industries back of the tariff wall German workmen and business men would become educated in industrial and mechanical pursuits and thus would be able to develop new methods and industries. Reliance was placed upon the factor of national education for industry; for it was appreciated that experience gained in one line was transferable to other industries. It was further recognized that an industry was most likely to succeed in an industrial environment. List's argument thus differed from the infant industry argument in that it was much broader in scope and involved a much wider concept of the possibility of molding the whole life of a people. The object was, not only to enable future consumers to obtain goods more advantageously, but also to influence the cultural life of the nation by fostering a variety of pursuits.

The point was emphasized by List and his followers that the protectionist policy like the free trade policy was limited in its proper application. Free trade was the correct policy for a country such as England, which had reached the manufacturing stage—the final stage of industrial evolution. It was likewise the best policy for tropical countries and others which were not naturally fitted to develop into the higher stage.

There seems to be much force in List's contentions, and they constitute perhaps the most tenable support of a protectionist program. They meet the free trader's argument at its weakest point, *i. e.*, the assumption of a static state of industry and international division of labor. Assuming a certain type of industry in each of the countries of the world, there can be little doubt that the greatest possible sum of economic goods will be produced and will be available for consumption under a system of unfettered exchange and specialization. But the dogmatic free trader overlooks, or at least minimizes, the importance of the fact that a nationally organized society may have aspirations to mold its economic system in a certain manner, perhaps for purely economic or perhaps for political, cultural, or military purposes. The free trader is an individualist; in his opinion the intelligent, self-seeking, economic man will so direct his production and his buying and selling as to best advance his own self-interest and thereby the interest of his group. The philosophic protectionist conceives man as a political animal,—first and always a member of a national group which has, or may have, aspirations and ambitions. According to this view it is only through a balancing of individual activities and group activities that men can best satisfy their ambitions.

More specifically, these national aspirations have, in the last century or more, been directed toward a development of manufacturing within the country. The advantages which have accrued to England as the pioneer in this field have been apparent to all. These advantages have not been confined to the direct benefit of the greater output of the manufacturing industries in making possible a higher standard of consumption for the general

populace, but they are to be found in the spread of education, the development of democratic institutions, and the growth of national power. Having established itself securely in these lines, England has turned to free trade. That this is the wise policy for England most people would admit; that it is the proper policy for other countries which are traveling, or hope to travel, the road over which England has come does not necessarily follow.

Tariff Making in Practice

Many students who concede the force of this line of argument are still opponents of a protectionist policy in its practical application. The point is well illustrated by the experience of Alfred Marshall, English economist. The following excerpt is from a memorandum prepared for the government of Great Britain on the fiscal policy of international trade: "I for one was so much impressed by those arguments of Carey [1] and his followers, which had found scarcely any echo in English literature, that I went to the United States in 1875 to study the problems of national industry and international trade from the American point of view: and I was quite prepared to learn, not indeed that the American system was applicable to England, but that it might contain ideas capable of adaptation to English conditions. I came back convinced that a protective policy in fact was a very different thing from a protective policy as painted by sanguine economists, such as Carey and his followers, who assumed that all other people would be as upright as they knew themselves to be, and as clear-sighted as they believed themselves to be. I found that, however simple the plan on which a protective policy started, it was drawn on irresistibly to become intricate; and to lend its chief aid to those industries which were already strong enough to do without it. In becoming intricate it became corrupt; and tended to corrupt general politics. On the whole, I thought that this moral harm far outweighed any small net benefit which it might be capable of conferring on American industry

[1] Henry Carey (1793–1879), American economist who, like List, argued for protection for infant industries.

in the stage in which it was then. Subsequent observation of the course of politics in America and elsewhere has strengthened this conviction. It seems to me that the policy adopted in England sixty years ago remains the best, and may probably remain the best, in spite of increasingly rapid economic change, because it is *not* a device, but the absence of any device. A device contrived to deal with any set of conditions must become obsolete when they change. The simplicity and naturalness of Free Trade—that is the absence of any device—may continue to outweigh the series of different small gains which could be obtained by any manipulation of tariffs, however scientific and astute." [1]

The practical difficulty of putting a protectionist policy into effect in a truly statesmanlike manner is certainly one of the most potent objections to it. Such a policy must necessarily consist in practice of a multitude of special aids; and the representatives of the various industries are bound to exert an unwholesome influence upon legislation in their efforts to turn the general policy of the government to their own advantage. Furthermore, no matter how conscientious legislators may be, it is a practical impossibility to decide, certainly by the legislative methods common to representative governments, just what industries should be encouraged, how much protection should be given, and how long it should be continued. Protection once given comes quickly to be viewed as a vested interest; and it is very easy for a policy, which at the outset was conceived to be only temporary, to become saddled upon a people as a permanent system. This is well illustrated by American tariff history. At the outset the developmental theory was put forward in support of protection; but, as some of the protected industries passed definitely beyond the infant stage, there has been a tendency to justify the continuance of protection as a permanent policy. It then became the "American system" that is, a thoroughgoing protectionist doctrine making no concessions but representing itself as the proper policy both permanently and generally for American trade.

[1] Alfred Marshall, *Fiscal Policy of International Trade*, p. 15. Printed by order of The House of Commons, 11 November, 1908. Reprinted in part in F. W. Taussig, *Selected Readings in International Trade and Tariff Problems*.

The Effect of a Tariff upon Prices

A fact which has tended to complicate the tariff controversy is that it is practically impossible to measure the precise effect of a tariff upon prices and upon the direction of industry in the tariff-levying country. Too many factors are usually at work to make possible an accurate check of the effect of specific measures. We, therefore, are forced to rely upon deductive reasoning. This question is equally significant for the protectionist and the free trader for it seems obvious that the tariff is effective in protecting domestic industries only if it affects domestic prices. There are some products which will always be produced in the country where they are to be consumed regardless of the relative cost of production in that country and abroad. Such are houses, highways, railroads, certain perishable goods, such as garden truck and some dairy products. Gravel, stone, and coal will be internationally exchanged only when a very great difference in cost of production obtains between the exporting and importing countries. That is, there is with these products a more or less perfect protection to the domestic producers in the natural difficulty of exchange. The protective controversy is limited, therefore, to those goods which in their nature are "international" products.

Even as to these international products there are certain conditions under which a tariff will have no effect upon prices or upon the direction of industry. First, if a product is produced in a country at a cost as low as, or lower than, the cost of production abroad the product is not likely to be imported, either with or without a duty; and, therefore, the levying of a duty will presumably have no effect upon prices or industry nor will revenue be yielded by it. Sometimes under these conditions a certain amount of the product may be imported, merely taking the place of an equal amount of the domestic product exported. Canadian wheat imported into the United States is a case in point. We export a part of our annual wheat crop. Assuming no interference in exportation, the price of wheat sold for domestic use must be equal to the price obtained for the exported wheat minus the

costs incident to its foreign sale. If the price were lower than this, wheat would be bought up for export until the curtailment of the domestic supply raised the price here. If it were higher than this, no wheat would be exported and, indeed, foreign wheat might be imported until the price fell. Thus wheat for export and wheat for domestic use must, and in fact does, yield the same price to the American producer or other owner. Under these circumstances any importation of wheat into the United States will not affect the price here for our domestic market is already supplied with all the wheat which it is willing to take at a price which makes it profitable to sell here rather than to export it. Any addition to the supply of wheat in this country, therefore, whether by domestic production or import, merely leads to larger exports: the price received by our producers is not affected, nor is the character of American agriculture influenced.

The point may be made more clear by another way of viewing the problem, which leads to the same result. As explained above there must be a certain relationship between the price of wheat in Liverpool and its price in the United States. One of the factors in determining this price is the supply of Canadian wheat. Thus the Canadian wheat and the American wheat come in competition on the Liverpool market and there exert their influence upon the price for the whole supply. Now to prevent Canadian wheat from entering the United States, merely forces the competition to take place on the world market instead of on the domestic market. Compete they must as long as both countries are exporting a part of their supply. A duty, therefore, which is intentended to check such imports can have no effect other than to influence the selection of channels through which the Canadian wheat will be marketed.

A second case in which the tariff duty will have no effect upon the direction of industry is a duty upon products which cannot be produced or can be produced only at prohibitive costs within the country. Examples are duties upon tea and coffee. In their cases, unlike the previous one, prices are affected but the increased prices act only as taxes upon the consumers of the goods,

and the government receives that which the consumers pay. Consumers presumably buy somewhat less of the goods in question because of the higher price, and, to that extent, the free flow of international trade is checked. The object of such duties, however, is revenue or regulation of consumption, not protection.

Third, an import duty may be shorn of its protective character by an internal revenue tax upon domestic producers equal to the import duty. Such a combination of measures thus becomes purely a revenue-collecting device. The consumption of the product will be somewhat reduced; the price of the product is raised; but the government treasury collects an amount equal to that paid by consumers in higher prices.

Fourth, we have products which could be domestically produced but only at a cost higher than that which obtains in foreign countries. Such products will be imported unless some device is employed to offset the disadvantage under which the domestic producer labors. This device may be a subsidy paid to the producer, as explained below, or a customs duty levied upon the imported goods sufficient to raise the price of these goods to a level which will enable the domestic producer to sell his goods at a profit.

A tax upon such products which is less than the excess of domestic cost over foreign cost plus transportation will raise prices somewhat but will not enable the domestic producers to enter the field. It will thus be purely a revenue measure and will be similar in its effects to duties on products not producible at home. Thus if the foreign and domestic costs are as follows:

Foreign cost of production	10 cents
Transportation cost	10 cents
Price of imported product	20 cents
Domestic cost	30 cents

then a duty of 5 cents upon the foreign products will raise the price to the consumers to 25 cents but still will not enable the domestic producer to compete. The government will collect 5 cents upon each unit of the product consumed.

But if the duty is placed at 10 cents the foreign and domestic

producers will be placed on the same footing. This example in its very simple way, illustrates the "competitive" or so-called "scientific" tariff, which has received so much attention of late in the American tariff controversy. From the point of view of the free trader it is far from "scientific" for it deliberately nullifies the natural advantages which other countries have in producing certain goods and deprives the consumers of the benefits of international trade. Carried out consistently and generally it would result in the cessation of all trade between countries, for trade is of course based on just such differences in costs as are here neutralized.

The duty, in this case, will normally have the effect, first, of limiting the supply until the price rises high enough to cover both the foreign costs and the duty. But at this price the American manufacturer, being free of any special duty, will be able to enter the field. He may, indeed, because of inertia or fear that the protection will soon be removed, not enter the lists at this point; on the other hand, he may be able to capture the market completely, or the market may be divided between the domestic and foreign producer. Any one of these results may follow. If the American industry is in fact not stimulated the duty will be in effect a revenue measure only: prices will rise but the government will gain all that the consumer loses. If the American-made products displace the foreign products entirely the government will obtain no revenue, consumers will pay a price higher by the amount of the duty, this addition to price going to offset the higher cost of production. If the market is divided the consumers pay a higher price than before on the whole supply. This increased amount paid goes to the government in so far as the product is imported and in so far as the product is produced here it goes to domestic producers to cover higher costs. It should be noted that this amount paid to the domestic producer is not in the nature of a net profit to him. It represents the loss to the community as a whole from directing industry into relatively ineffective lines. The real loss to the community on this score is thus proportional to the success of the tariff policy in establishing the

domestic industry. Some protectionists would reply that, although this might be the temporary effect, the domestic industry would so increase its effectiveness with larger production and with the accumulation of experience that before long its disadvantages would quite disappear. This is possible and if it does come about the protecting duty will no longer be required; but so long as the duty remains, and domestic manufacturers do in fact rely upon it, the results indicated are likely to follow.

A third possibility is that the duty may be higher than necessary to offset the difference between domestic and foreign costs. Such a duty will effectively stop imports and establish the domestic producers in the field. The effect upon price will depend upon the degree of competition existing among the domestic producers themselves. If competition is keen, the price will be fixed somewhere near the domestic cost of production. This will be higher than the foreign cost but not higher by the amount of the duty. In this case that part of the duty by which it exceeded the difference between foreign and domestic costs would be ineffective either for revenue or protection. If, however, there is a degree of monopoly in the domestic market, the high tariff may enable the monopoly to advance its prices with a freer hand than if the foreign competition could enter at any point above the domestic costs. It is unlikely that the tariff would lead to the creation of a trust; but, a degree of price control existing, it might, if the duties were too high, accentuate the evil.

The following table presents the various uses for and types of customs duties together with the probable effect of each upon prices, upon the character of domestic industry, and upon the public revenues. It is intended only for convenient summary, and it should be interpreted in the light of the preceding discussion. These conclusions are based upon the assumption of an absence of interference with exporting and importing other than that provided by the tariff itself and also upon the assumption of competition between foreign producers. Some qualifications which appear to be necessary where such competition is not present are noted below in another connection.

Duty Levied upon	Effect on Prices	Effect on the Domestic Industry	Effect on Public Revenue
I. Product which we normally export.	No effect.	No effect.	May collect some duty, if imports continue.
II. Product which cannot be domestically produced.	Raised by amount of duty.	No effect.	Total increase in price goes to treasury.
III. Imported product which could be domestically produced but at higher cost.			
a. Duty less than difference in costs.	Raised by amount of duty.	No effect.	Total increase in price goes to treasury.
b. Duty equal to difference in costs.	Raised by amount of duty.	Encouraged. Market probably divided.	Duty collected only on goods still imported.
c. Duty greater than difference in costs.	Raised, but by less than amount of duty.	Encouraged. Whole market reserved to domestic producers.	No revenues.
d. Import duty accompanied by an equal internal tax.	Raised by amount of duty.	No effect, except to reduce consumption.	Total increase in price goes to treasury.

So far we have given no consideration to the argument that the foreign producer pays the tax. When Mr. Dooley's friend raised this argument he was told that the foreigner paid the tax—*if* he succeeded in getting past Ellis Island. Probably this is as sound as any simple generalization is likely to be, and yet there are exceptions. First, to state the normal case: the foreign producers are ordinarily in competition, which fact fixes a price somewhere near the marginal cost of production and, further, the foreign producers ordinarily have several markets or possible markets for their wares, other than the one of the tariff-levying country. Under these circumstances, when confronted by a tariff duty, they will turn to other markets until the price in the protected market rises high enough to enable them to obtain their net price after the duty has been paid; that is, the consumer in the duty-levying country pays the tax.

Suppose, however, that the foreign producers do not in fact

have alternative markets of any consequence. Under this condition the supply existing at the time the duty was levied would so press upon the relatively small foreign demand as to depress the price of the product to a point at which it could be imported and sold at a price little if any higher than that which prevailed before the duty was levied. That is, the foreign producers would be forced to stand the loss occasioned by the duty. Ordinarily, under these conditions, some of the less efficient foreign producers (those at the margin) would be forced out of business. The result would be such a reduced output that the price would again rise and the consumer would thus be forced to pay the tax. If, however, we add that the foreign producers are operating with a large fixed plant they may continue production for some time, themselves bearing the loss of the duty rather than to suffer the still greater loss which would result from dismantling their plants. Even under this condition, however, the assumption of the burden by the foreigner would come to an end sooner or later; for as plant and equipment wore out they would not be replaced, and in time the supply would be so reduced as to force a higher price.

One other condition which might result in placing the burden of the duty upon the foreign producer is that the product is produced by a monopoly. Here we refer to monopoly in the usual sense, *i. e.*, control of the supply by a single business man or group of business men, not merely in the sense of the total foreign supply's being produced in one country. If this condition obtained, the price prior to the levying of the duty would be fixed at the point which would yield the highest net return to the monopolist; and it might be to the advantage of the monopolist to stand the duty himself, rather than to suffer the loss of demand which would be occasioned by raising the price.

This result may follow, at least temporarily, from such a *quasi* monopoly as is occasioned by a well known trade-mark or goodwill possessed by the foreign producer. Further, as the protectionist often points out, if the duty establishes the domestic industry on a competitive basis this competition may force the foreign producer to forego part of his monopoly advantage and

lower his price, not indeed to his own cost of production, but to the domestic producer's cost of production. Therefore, in a sense, the foreigner would bear the tax burden.

Thus we see that no satisfactory general answer can be made to the question, "Who pays the tax?" The presumption is that since the duty has the effect of increasing the cost of getting goods to the consumers of the duty-levying country this increased cost will be borne by those consumers in the form of higher prices. If, however, the foreign producers are especially dependent upon this market as an outlet for their goods they may be temporarily forced to bear the tax or, second, if the foreign products have been sold at a monopoly price an additional tax may not increase that price but may be taken out of the monopolist's net profits.

Subsidies

The development of the industry of a country may be influenced by the government by means of subsidies or bounties instead of by the tariff. Whereas the tariff attempts to establish certain industries in the country by artificially raising the price until it is high enough to cover domestic costs of production, the subsidy or bounty works directly, being a premium paid by the government to the domestic producer, with a view to overcoming the disadvantage suffered by him. The operation and incidental effects of the two devices are likely to be quite different. The duty operates by raising the price of the product in question and thus places the burden of establishing the industry upon the consumers of that product in proportion to the amount of the product consumed. There seems to be little justification for distributing the burden in this way. If, for example, it is deemed wise for military or other national reasons to foster the home manufacture of dyes and chemicals is there any reason why the present consumers of these goods should bear the burden? The subsidy recognizes this as a legitimate national project, the burden of which should be borne by the members of the whole community in proportion as they contribute to other common expenses.

It may be replied that the tariff yields a revenue to the government over and above that which goes to the producer in the form of higher prices. It should be remembered, however, that in so far as the tariff yields a revenue it fails to protect. The revenue to the government is paid only on those units of the product which continue to be imported in spite of the duty. The duty really protects only so far as it effectively keeps out foreign products. There is no way by which the same dollar taken from the consumer can serve both the purpose of public revenue and protection.

Another difference is that the tariff by raising the price of the product in question presumably diminishes the demand for it and thus, to a certain extent, defeats its own object. The importance of this effect depends, of course, upon the degree to which the particular demand is influenced by price, *i. e.*, upon the elasticity of demand.

The effect of the subsidy on the domestic producers seems to be more pronounced than that of a tariff. If the foreign cost is eight cents and the domestic cost ten cents it would seem at first sight that an increase of the domestic price to ten cents (by a two-cent duty) would be just as effective as would a premium of two cents paid to the domestic producers. The psychological value of the second, however, seems to be greater. It is more direct and easily measured. This conclusion seems to be borne out by the results of the bounty on cane sugar in the tariff of 1890.[1]

But the great advantage of the subsidy (or disadvantage, according to one's point of view) is that the whole question is brought into the light. The amount of cost involved in diverting industry from its natural channels into the ones desired is made perfectly clear. The cost would likely be no greater by the one method than the other; but with the subsidy it is apparent, while with the tariff it is more or less disguised. It is precisely for this reason that the subsidy is never likely to become popular in a country having a representative government.

While it is highly important that the student should acquaint

[1] *Cf.* F. W. Taussig, *Some Aspects of the Tariff Problem*, p. 56.

himself with the principles involved in the tariff controversy it is probably true that the practical effect of the tariff, in this country at least, has been much exaggerated by both protectionists and free traders. Our economic destiny has been insured by factors far more fundamental than our national policy toward foreign trade. A country of vast extent and of the most varied and abundant resources, occupied by a venturesome people with free institutions,—given these and other favoring circumstances which have been present, a country could hardly fail to develop a great industry and trade and to attain a high degree of productivity and a high standard of living. The most significant fact concerning our commercial policy has been the free trade between the different parts of the United States. As regards our policy toward other countries, the only question is whether it has hastened or delayed our economic progress.[1] The reason for this relatively insignificant effect of the tariff in the country which has perhaps made more use of it than any other country is to be found in the opportunity for territorial division of labor within the country and the wide extent of our own market. As noted in a previous chapter, American conditions have tended to foster a relatively greater development of and reliance upon domestic trade than foreign trade.

The tariff controversy in this country is likely to attract less attention in the future than in the past. As American manufacturers, in whose favor most protection has been granted in the past, are themselves turning to foreign trade they appear to realize that trade is reciprocal and that a refusal to buy from foreigners can only limit our sale of American manufactured goods to foreigners. A continued shift in our comparative advantage from agriculture to manufacturing may indeed lead to a widespread demand by our farmers for protection against foreign producers of foodstuffs. In this event we should naturally expect to find the farming interests opposed by those of manufacturers as we did in England in the first half of the last century.

[1] For some very enlightening studies of the effect of the tariff upon some of our important industries, see F. W. Taussig, *op. cit.*

The economic basis for such a contest, however, has not as yet been laid, nor is it likely to be in the now discernible future.

Bargaining Tariffs

The commercial policies of the high tariff countries have two objects: first, to produce at home as many and as much of the products consumed as possible and, second, to export as much of domestic products as possible. Broadly speaking, these two ideals are inconsistent because trade consists of an exchange of goods for goods, and if a country arbitrarily limits its imports by protective duties, it thereby limits the possibilities of selling its own goods abroad. This conclusion follows from the principles of trade discussed above. But another and more obvious obstacle to the realization of these aims is the very general use of customs duties. Country A by levying a tariff attempts to reserve its market to domestic producers, but country B follows the same policy. Thus while country A has attained, by its own tariff, the first object mentioned above, it is prevented from attaining the second object by the tariff of country B. If the desire to sell goods to B is sufficiently strong and the obstacle of B's tariff sufficiently burdensome, A is likely to try to induce country B to lower the duties upon A's products. This inducement usually has to do with a modification of A's tariff. Thus the tariff comes to be used for bargaining purposes in an effort to open markets to domestic exporters.

Most products which are the subjects of international trade are sold in competition with similar products produced in other countries. It is, therefore, of the greatest importance to the exporters of any country that the duty charged upon their goods in the importing countries shall not be higher than the duty charged against the competing products of the other exporting countries. Indeed, it would be highly advantageous to them to obtain a lower rate upon their goods than is charged upon competing goods. One object, therefore, of a government seeking to advance the interests of its exporters is to obtain special tariff concessions, but if special concessions appear not to be feasible then

it will attempt to insure equality of treatment. The former is commonly attained by granting concessions in duties to the country from whom the special favor is sought; the latter is best attained by the use of the "most favored nation" agreement. By this agreement two countries agree to extend each to the other the benefit of any concessions made to any other countries. That is, each of the two countries is assured, as regards the tariff of the other, that it will enjoy the benefits of rates given to the most favored nation. Now if most of the important trading countries give and accept, by reciprocal commercial treaties, assurances of most favored nation treatment, it is evident that the possibility of any one country obtaining special favors for its nationals is greatly reduced.

This is practically the situation which prevails among the leading commercial countries to-day.[1] The trading world is covered by a network of special treaties but as most of them include a most favored nation clause the result is less complicated than it might otherwise be. But the possibility of obtaining special favors is not entirely removed. In the first place the clause in question is subject to, and has received, two interpretations: the one is that implied above, namely, that a concession given shall freely and automatically be extended to others with whom the most favored nation agreement exists. The other is that the country with whom the agreement exists shall have the right to avail itself of the concession upon terms identical with or similar to those given to the original country. Country A makes a concession to country B in return for valuable privileges granted by B. A may grant the concession to C and D with whom most favored nation agreements exist only if C and D are willing to give in return the consideration given by B. This, which may be termed the conditional interpretation or form, is that which has been traditionally favored by the United States: the former or

[1] Modern tariff systems and commercial treaties are treated here in a very summary manner because to give these subjects the attention which they deserve would require far more space than can be devoted to them at this point. They have been treated in a very thorough and comprehensive manner in the report of the United States Tariff Commission on Reciprocity and Commercial Treaties, a study which is commended to those who wish to pursue the subject further.

unconditional interpretation represents the European view. The former tends to generalize at once all concessions among the countries with whom the agreement exists; the latter leaves it to each country to decide for itself whether or not it will accept the concession on the terms offered. Since the European war, however, the United States, which was the principal adherent of the conditional form, has reversed its position.[1] Treaties recently negotiated by our State Department have included the European form of agreement and the department has announced that this form of the agreement will be employed in the future and that existing treaties embodying the opposite view will be revised where possible. Apparently this difference of interpretation will cease to be effective as a cause of diversity of tariff relations.

Another factor that prevents the most favored nation clause from generalizing all concessions is the practice of describing concessions in such a way that they will be effective only as regards the original favored country, although formally they extend to all countries entitled to most favored nation treatment. An extreme example is a German tariff concession which accorded a special rate to "large dappled mountain cattle or brown cattle reared at a spot at least 300 meters above sea level and which have at least one month's grazing each year at a spot at least 800 meters above sea level." This concession could safely be extended to other countries to whom Germany was bound to extend most favored nation treatment without fear that it would actually apply to any country but Switzerland, in whose favor it was originally made. Recent tariff developments have shown a tendency toward increasing specialization in the description of products—no doubt with a view to retaining a free hand in making special concessions in spite of the prevalence of most favored nation agreements.

The possibility of obtaining either specially favorable treatment or equality of treatment by means of mutual agreements

[1] *Cf.* Jacob Viner, The Most-Favored-Nation Clause in American Commercial Treaties. *Journal of Political Economy*, February, 1924.

has led to the framing of tariff laws for the purpose of bargaining as well as for protection and revenue. This custom has led in many countries to a departure from the single tariff system, whereby one schedule of duties is made applicable to all products whatever their origin. Such a system has obvious disadvantages for bargaining purposes. Opposed to the single tariff are various types of multiple tariffs. The general and conventional system includes, first, a general tariff enacted by the legislature of the country to apply to goods imported without reference to their source and, second, certain rates which have been set by conventions or treaties with other countries. Where agreements are made with specific countries, covering the rates to be charged upon goods from those countries, these agreements supersede the general tariff. Thus the tariff systems of several European countries consist in part of the general rates fixed by statute and in part of special rates granted by treaties. Indeed, the conventional rates may become so numerous and their application so broad through the working of the most favored nation clause that they will cover most imports and hence for practical purposes, the general rates will cease to be effective. Another type of multiple tariff is the maximum and minimum system whereby two tariff schedules are enacted by the legislature—the higher to be taken as a starting point and the lower to be extended in whole or in part to the products of those countries which grant equally favorable treatment or perhaps to those countries which refrain from discriminating against the products of the country in question. In fact, the minimum tariff may be so generally applied that the application of the maximum rates would be a penalty. A third type, the preferential system, differs from the preceding one in that a third schedule is established which applies only to a specified country or group of countries. Canada, for example, grants its lowest rates only to England and to other parts of the Empire which give reciprocally favorable treatment to Canada. An intermediate schedule applies to other countries which extend most favored nation treatment and a third, a maximum schedule, applies to all other countries.

These methods of influencing the tariff policies of foreign countries are conciliatory in form. A reduction in rates or some other valuable concession is granted in consideration of a similar reduction in rates or promise of equality of treatment by other countries. There exists, in other words, something akin to a contractual relationship. On the other hand, a country may employ a penalty, as, in fact, has been done by the United States in its recent tariff history. The tariff act of 1890 after providing for the free importation of sugar, molasses, coffee, tea, and hides provided further that penalty duties should be levied upon these articles when imported from countries whose duties upon American goods were, in the opinion of the President, discriminatory and unreasonable in view of the free admission of the products named. The amount of these penalty duties was specified in the law. The executive department was thus enabled to enter into negotiations for tariff concessions with the power to impose penalties if the concessions were not forthcoming. Under this act ten agreements were made and the penalty duties were applied in three instances. The penalty provision was removed by the act of 1894. The act of 1897 provided for both concessions to be granted and penalties applied. Several treaties were concluded and others were negotiated but not ratified. The proposed penalty on coffee was a factor in obtaining reduced rates upon the products of the United States imported into Brazil. The act of 1909 provided for two schedules, the maximum to be higher than the minimum by twenty-five per cent of the value of the articles. The higher schedule of rates nominally constituted the general tariff; but the lower rates were universally applied so that in fact the imposition of the higher rates to any country would have acted as a penalty. The tariff act of 1922 (section 317) authorizes the President to impose, in addition to the regular rates, special duties not to exceed 50 per cent ad valorem against the products of countries which in his opinion are discriminating unfairly against the products of the United States. The penalty method is thought to be more combative than the concession method and it has in fact been used in an

extreme manner by certain European countries in tariff wars. With the exception of such tariff wars the methods often differ more in form than in substance.

The spirit in which bargains are made is no doubt more important than the methods used. Bargaining tariffs may be used to obtain specially favorable treatment from foreign countries or merely to prevent unfair discrimination against a country's products. This should be the policy of any country which desires to avoid disputes, reprisals, and international controversies. But the thorough application of a policy of equality in tariff matters is, in the nature of the case, extremely difficult. Even though the same rate of duty be applied to an article regardless of its origin it will in fact bear heavily upon some countries while others may not be affected at all, because the product taxed may be an important export of the one, while it is not exported at all from the other. This natural difficulty of treating all countries alike is enhanced by a policy of special agreements combined with the conditional form of most favored nation clause. Special agreements are necessarily discriminatory and if tariff reductions made by such agreements are not immediately and freely extended to other countries they are almost bound to lead to inequality of treatment and to result in reprisals and disputes.

The general principle of equality of treatment is not necessarily violated by preferential treatment granted because of special political ties. Thus it would seem that the especially low duties levied by Canada upon imports from Great Britain could hardly be considered an unreasonable discrimination against other countries. Likewise the fact of geographical contiguity may justify special arrangements. Examples of such agreements are to be found in the tariff history of the United States. A reciprocity agreement existed between the United States and Hawaii prior to the annexation of the latter, and between Canada and the United States between 1854 and 1866. A new offer made by the United States in 1911 was not accepted by Canada. An existing special arrangement between Cuba and the United States is defended both on the ground of contiguity and on the ground of political ties.

The use of bargaining tariff systems and commercial treaties would seem to make for moderation and reasonableness in tariff matters. No doubt the system has this effect to a certain extent but as a matter of fact these desirable results are less conspicuous than they might otherwise be were it not for the fact that each country, when once it recognizes the bargaining possibilities, is likely to enact higher rates than it otherwise would, only to reduce these rates in return for like treatment by other countries. In other words, it is suspected that the low rates finally conceded are much the same rates as would have been granted in the first instance had there been no thought of the bargaining possibilities.

It has often happened that tariff concessions have been granted upon products which would not in any event be produced by the country granting the concessions. From any point of view, except possibly that of public revenue, it is to the advantage of a country to admit such products freely, and yet the country may establish a duty only to repeal it in return for a similar concession on the part of another country, which perhaps is playing the same game. In some respects our tariff agreements under the act of 1890 were of this sort, in that duties on certain tropical products, which we did not produce, were remitted in return for a remission of duty upon our manufactured goods into countries which had no manufactures. It was an absurd situation, and one which was a constant source of irritation and ill will. The general adoption of the most favored nation agreement only reduces the opportunity for such tactics.

In our commerce with European countries in the past we have been in an advantageous position because our leading exports to them (cotton, copper, and other raw materials and, to a somewhat less extent, food products) have been so essential to them that the self-interests of those countries encouraged a reasonable treatment of our goods. European products, on the other hand, have not been so essential to us. To the extent that manufactured goods come to assume a relatively more important place in our export trade and come into competition with European products we will tend to lose that favored position. It is possible, there-

fore, that the future, more than the past, will unfold sources of friction in our tariff making.

The effect of special concessions upon the domestic price of the products directly affected offers an interesting sequel to the analysis of the general effect of duties upon prices in a preceding section. If the concession is generalized or if practically the total imported supply of the product comes from the country to which the concession is made, the effect normally will be to fix a price in the importing country equal to the foreign price plus necessary costs incident to the importation of the product in question. If, however, a duty is abolished in favor of a country which supplies only a part of the domestic consumption while a substantial part of the supply continues to come from a country or countries which are required to pay the duty, then the price of the whole supply normally will remain at a point which covers foreign costs, transportation costs, and the duty. Those specially favored foreign producers who do not pay the duty will not sell for any less than do the others, and thus the whole saving of the tariff reduction will accrue to those producers. In the terms of price theory the duty paying units become the marginal units of the supply, and the price of the whole supply will be high enough to cover the cost of the marginal units. This situation apparently obtained in the concessions made on Hawaiian sugar in 1875. Hawaiian sugar constituted only a small part of the American sugar imports. When the duty was reduced upon this sugar but still levied upon the bulk of imported sugar, the only effect was to enhance the profits of the Hawaiian producers.[1] This should be borne in mind, for it is often assumed that any reduction of rates through reciprocity agreements will react to the benefit of consumers in the importing country. Whether or not it will do so depends largely upon the proportion of the supply affected by the reduced rates.

This brief discussion of international tariff agreements suffices to indicate that the commercial countries regard tariffs and tariff making as matters of not only national but international

[1] F. W. Taussig, *op. cit.*, Chap. V.

concern. Writers on international law usually class the making of tariffs among those activities of governments which are entirely controlled by national interests; and most nations view their control over tariffs as a matter in which their national sovereignty must be most jealously guarded. Nevertheless, concessions which sometimes amount to a limitation upon a country's freedom of action are often made. Such concessions have in most cases been in the form of special treaties between two countries. These instances raise the question as to whether nations will ever consent to a more general international control over tariff rates and administration. Some experiments in very limited fields have been made. The Sugar Convention of 1902 grew out of the desire of European countries to limit the bounties paid upon the production of beet sugar. An international commission was established which had the power to determine upon countervailing duties to be levied by the several signatory powers against any country, whether a party to the agreement or not, which, in the judgment of the commission was paying a bounty, either direct or indirect, upon the production of sugar. A mere majority vote of the commission was sufficient to make its findings effective and tariff rates which did not approve themselves to the governments of the countries involved, were actually ordered by the commission and enforced by individual states.[1] The signatory powers were Great Britain, Germany, Austria-Hungary, Belgium, Spain, France, Italy, the Netherlands, and Sweden.

Countries that are bound together by political ties or whose economic interests have been especially interdependent have at times yielded all or a part of their individual control over tariff matters to a tariff union. These are very slight bases upon which to rest a prediction as to future developments and no such prediction is here ventured. It remains, however, an interesting subject for speculation whether in a matter which so vitally affects the interests of all trading countries some general international control may not at some future time be established.

[1] P. S. Reinsch, *Public International Unions*, pp. 49–51, and text of the treaty in F. B. Sayre, *Experiments in International Administration*, Appendix C.

SUGGESTED READINGS

It is not the purpose of this note to give a list of all works deserving attention, nor even to select the best treatises, but rather to suggest books representing a variety of views and modes of treatment, and to characterize each in such a way as to assist the reader in selecting a balanced list of readings to supplement the discussion in the present text.

The Theory of International Trade

For a statement of the theory of international trade by the great expositor of the classical school of economics see John Stuart Mill, *Principles of Political Economy*, 1848, Book 3, Chapters 17 and 18. C. F. Bastable, *The Theory of International Trade* (Macmillan, New York, 1897) is a more extended exposition of the same doctrine, with some applications to governmental policy. An excellent statement in more condensed form is to be found in F. W. Taussig, *Principles of Economics* (Macmillan, New York, 1921), Chapters 32–35, inclusive; while the same writer's *Some Aspects of the Tariff Problem* (Harvard University Press, 1915), especially Chapter 3, contains perhaps the best short statement of the principle of comparative cost. Taussig, *Selected Readings in International Trade and Tariff Problems* (Ginn and Co., Boston, 1921) makes available to the student the writings of the chief contributors to the theory of international trade.

Foreign Exchange

A very lucid exposition of the general aspects of the subject is E. S. Furniss, *Foreign Exchange* (Houghton, Mifflin Co., Boston, 1922). I. B. Cross, *Domestic and Foreign Exchange* (Macmillan, New York, 1923) and A. C. Whitaker, *Foreign Exchange* (D. Appleton Co., New York, 1920) are more detailed and concrete expositions. On the interesting questions of exchange under the present disturbed conditions there are recommended F. W. Taussig, "International Exchange under Inconvertible Paper Money" (*Quarterly Journal of Economics*, May, 1917) and Alfred Marshall, *Money, Credit and Commerce* (Macmillan and Company, London, 1923). On the subject of purchasing power parities the writings of Gustav Cassel are recommended, especially his *Money and Foreign Exchange after 1914* (Macmillan, New York, 1922). For a brief statistical application of purchasing power parities, see a report by the United States Tariff Commission, *Depreciated Exchange and International Trade* (Washington, D. C., 1922).

The Balance of Trade

A general discussion of the theory of the balance of trade and its present day application to the trade of certain countries is in Theodore Boggs,

The International Trade Balance in Theory and Practice (Macmillan, New York, 1922). A detailed study of the history of the balance of trade in this country is "The Balance of Trade of the United States," by C. J. Bullock, J. H. Williams and R. S. Tucker (*The Review of Economic Statistics*, Harvard University Press, July, 1919, reprinted in part in Taussig, *Readings in International Trade*). A recent computation has been made by J. H. Williams and R. S. Tucker in "The Balance of International Payments of the United States, 1922" (Bureau of Foreign and Domestic Commerce, Trade Information Bulletin No. 144, Washington, D. C.).

Recent Tendencies in American Foreign Trade

Several articles have appeared in recent years on the present and future tendencies in American trade. Of these the following are recommended: F. W. Taussig, "The Present and Future of the International Trade of the United States," (*Quarterly Journal of Economics*, November, 1919.) W. A. Berridge, "An Analysis of the Exports of Merchandise from the United States" (*The Review of Economic Statistics*, Harvard University Press, October, 1919) and Simon Litman, "The Past Decade of the Foreign Commerce of the United States" (*American Economic Review*, June, 1920). On the whole history of the foreign commerce of the United States see Clive Day, *A History of Commerce*, Part V (Longmans, Green and Company, N. Y., 1908). For the original data consult: *Foreign Commerce and Navigation of the United States* and the *Statistical Abstract of the United States*, both published annually (Bureau of Foreign and Domestic Commerce, Washington, D. C.).

The Mercantile Organization for Foreign Trade

From the many books and pamphlets published on this subject in recent years the following are suggested: B. O. Hough, *Practical Exporting* (Johnson Export Publishing Company, New York, 1919). Among other valuable features this book includes a number of specimens of documents and papers employed in the everyday work of exporting. W. F. Wyman, *Export Merchandising* (McGraw-Hill, New York, 1922) treats especially the problems of selling manufactured goods in foreign markets. Others suggested are M. S. Rosenthal, *Technical Procedure in Exporting and Importing* (McGraw-Hill, New York, 1922) and J. A. DeHaas, *The Organization of Foreign Trade* (Ronald Press, New York, 1923)

Ocean Transportation

A satisfactory general treatment by an English writer is D. Owen's *Ocean Trade and Shipping* (Cambridge University Press, London, 1914), while a more detailed treatment applied more specifically to the United States is E. R. Johnson and G. G. Huebner, *Principles of Ocean Transportation* (Appleton, New York, 1918).

Financing Foreign Trade

The books by E. S. Furniss and A. C. Whitaker mentioned in connection with foreign exchange will be found helpful here. A. J. Wolfe, *Foreign Credits* (Bureau of Foreign and Domestic Commerce, Special Agents Series, No. 62, Washington, D. C.) presents and summarizes reports from American consular officers on terms of sale for American goods in foreign markets. *How Business With Foreign Countries is Financed*, compiled and published by the Guaranty Trust Company of New York, presents specimens of several documents used in financing foreign trade, together with a brief discussion of each. W. Ward, *American Commercial Credits* (Ronald Press, New York, 1922) deals with letters of credit.

Foreign Investments

C. K. Hobson, *The Export of Capital* (Macmillan, New York, 1914) is an exposition of the principles involved and the history of foreign investments, particularly from the English point of view. Estimates of the volume of American borrowing and lending will be found in the studies mentioned in connection with the balance of trade. J. A. Hobson, "An Economic Interpretation of Investments" (*The Financial Review of Reviews*, London, 1911) contains a good statement of some of the problems involved in foreign investments.

The Risk Element

C. O. Hardy, *Risk and Risk Bearing* (University of Chicago Press, 1923) treats of the general subject but without particular reference to foreign trade. On marine insurance see W. D. Winter, *Marine Insurance, its Principles and Practice* (McGraw-Hill, New York, 1920). On speculation and hedging in international products see any of several studies on organized exchanges. One of these which gives especial attention to international transactions is J. G. Smith, *Organized Produce Markets* (Longmans, Green and Company, London, 1922).

Government Interference

On the tariff controversy in the United States, consult the several writings of F. W. Taussig, especially his *Tariff History of the United States* (Putnams, New York, 1914) and *Some Aspects of the Tariff Problem* (Harvard University Press, 1915). An excellent consideration of the tariff question from the English point of view is Alfred Marshall's *Memorandum on the Fiscal Policy of International Trade* (Parliamentary Paper, 1908, reprinted in part in Taussig, *Readings in International Trade*). On the general subject of commercial policies, G. M. Fisk and P. S. Peirce, *International Commercial Policies* (Macmillan, 1923) is recommended. A more intensive study of certain phases of the question in the United States is *Reciprocity and Commercial Treaties* (The United States Tariff Commission, Washington, D. C., 1919).

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